MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

June 3, 2013

Norm Champ, Esq.
United States Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Dear Mr. Champ:

The Investment Company Act of 1940 ("1940 Act") assigns directors the responsibility to determine in good faith the value of securities in their fund portfolios that do not have readily available market quotations. The Mutual Fund Directors Forum ("Forum"), [1] an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Valuation – including the possibility that the Commission may issue new guidance – is thus an area in which our membership has a keen interest.

We welcome the opportunity to work with the Commission and the staff in this critical area.

I. Introduction

Appropriately valued portfolios ensure that fund investors, whether purchasing or redeeming shares (or indeed, staying invested in a particular fund) are treated fairly. Given the importance of the issue, we applaud your expressed willingness to engage with industry participants in ensuring that the Commission's guidance works for industry participants and fund shareholders, including your calls at the recent Mutual Funds and Investment Management Conference and elsewhere to open a dialogue with the independent director community with the goal to "maximize the value of fund boards for fund investors."[2]

As the only organization devoted exclusively to the interests and needs of independent directors, we at the Forum look forward to continuing the dialogue with both the SEC staff and the Commission to provide the perspective of fund boards to facilitate the development of proposed and final valuation guidance that serves the industry, fund boards, and fund investors for years to come. We believe that fund boards composed predominantly of independent directors are a unique, flexible and cost-effective means of ensuring that funds are operated and managed in the best interest of their investors – and director oversight of the valuation process is just another example of how they serve fund shareholders. Like you, we are committed to helping directors

[1] The Forum's current membership includes over 856 independent directors, representing 99 independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

[2] Remarks of Norm Champ to the 2013 Mutual Funds and Investment Management Conference, Palm Desert, California, March 18, 2013.

fulfill their valuation responsibilities. This letter, combined with guidance we produced for directors on valuation last year,[3] and our in-person events, is a key part of our efforts in this area.[4]

As we outline in detail below, we believe that two major principles should underlie any proposed guidance issued by the Commission – the guidance should be principles-based and should clearly recognize the authority of fund directors to delegate day-to-day responsibility for fair valuation consistent with the 1940 Act as interpreted by the staff for many years.

II. The Commission Should Issue Principles Based Guidance

Most fundamentally, we believe that in developing guidance on valuation, the Commission should focus on the principles that underlie and drive the valuation process, rather than on attempting to develop prescriptive approaches to valuing specific classes or types of securities. Doing so will permit the Commission to issue succinct guidance that is of real value to independent directors rather than a lengthy compendium of prior guidance and a list of potential approaches to various types of securities that, as we discuss below, would both be inflexible and be liable to become quickly outdated.

In recent years, many funds have expanded their investment strategies in response to an increasing appetite from investors for products designed to help meet their individual needs and goals, to save for the future, and effectively to diversify and reduce risk in their portfolios. Many of these new investment strategies have been facilitated by the introduction of newer and more complex securities. This evolution in the securities market will undoubtedly continue, and new securities will continue to be developed and introduced.

Given the rapid development of new types of securities, guidance that focuses on how to value specific currently existing securities will not be helpful in the long run to funds or their investors. Moreover, the methods of valuing securities that exist today may change as well, as the manner in which those securities are traded and the liquidity of those securities may change rapidly over time. Therefore, even relatively high-level guidance with respect to specific types of securities risks rapidly becoming outdated and potentially problematic. In contrast, principles-based guidance that focuses broadly on what funds should attempt to achieve when fair valuing portfolio securities is likely to lead to a better result – that is, more accurate individual security valuations and, most importantly, more accurate daily NAVs.

Principles-based guidance is the most effective and comprehensive way to address the wide variety of funds, boards, securities and investment instruments and product innovation and evolution in this dynamic industry. Through principles-based guidance, the Commission can emphasize the key goals that should drive a fund's valuation process, including that:

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3 *See* Mutual Fund Directors Forum Report, *Practical Guidance for Fund Directors on Oversight of Valuation*, June 2012 (Available at http://www.mfdf.org/images/uploads/newsroom/Valuation-web.pdf).

4 More broadly, we have also consistently worked with the Commission and the Division's staff to help develop approaches that will increase director's effectiveness on behalf of fund shareholders. *See, e.g.,* May 2, 2008 to Andrew J. Donohue (Available at http://www.mfdf.org/images/uploads/newsroom/DirectorDutiesMFDFLetterMay22008.pdf).

- Fair valuations should focus on what a security can currently be sold for in an orderly transaction.[5]

- Directors and advisers should work together to evaluate whether necessary resources are devoted to valuation, irrespective of whether those resources are developed internally or are outside vendors.

- The valuation process should be conducted pursuant to clear policies and procedures that set forth governing principles, including principles necessary to identify and evaluate situations in which exceptions to those procedures are made.

- Funds should have a means of identifying securities that, given current market conditions or other factors, cannot be valued on the basis of existing policies and procedures.

- Funds should not acquire securities unless they have the infrastructure, resources and policies and procedures in place to value those securities.

- Those managing the valuation process should have access to information and perspectives of portfolio managers and traders but be sufficiently independent so that any conflicts portfolio managers or traders have with respect to the valuation of securities are identified and minimized to the extent practicable.

- Fair valuations should be regularly reviewed in order to identify weaknesses in existing procedures.

- Funds with few complex and illiquid securities (or that always maintain such securities as a very small, immaterial percentage of their portfolios) may choose to employ different (and fewer) resources than funds that regularly devote a large percentage of their portfolios to such securities.

- Identified weaknesses in a fund's valuation processes should be addressed and valuation policies and procedures should be reviewed and periodically updated to respond to changing market conditions, the changing nature of a fund's portfolio or other relevant factors.

Most importantly, however, as all of the above examples demonstrate, carefully crafted guidance that focuses on principles rather than prescriptive rules and methodologies will provide funds and their directors necessary flexibility. Such guidance will make clear that directors can and should seek to approve and implement approaches to valuation that are responsive to the specific securities held by the funds they oversee and that are tailored to the portfolio management strategy employed by the fund and the related valuation risk issues that it faces. Directors

[5] In addition to articulating this point, clarification regarding what the Commission sees as an "orderly transaction" would be useful for fund boards as they work to effectively oversee the fair valuation process.

provide value to the investors in the funds they oversee precisely because they are able to apply broad regulatory principles and business judgment to the specific situations faced by their funds. Empowered in this manner, independent boards are highly effective – indeed, much more effective and efficient than any broad-based regulatory system ever could be – at maximizing the probability that each individual fund is operated in the best interests of its shareholders.

III. The Commission's Guidance Should Clearly Recognize the Authority of Directors to Delegate

The statutory requirement that fund directors fair value securities in their portfolios that do not have readily available market values envisions an informed, engaged and independent board acting in good faith with respect to the valuation of portfolio securities. But it does not require that boards themselves directly value portfolio securities. Rather, because mutual funds must calculate their NAVs daily, most boards adopt policies and procedures to govern the method in which the NAV is to be determined on a day-to-day basis.[6] Those procedures generally delegate to the adviser the determination of fair value for portfolio securities and other assets for which market quotations are not readily available. Delegation is appropriate both because the adviser generally has the required expertise to make judgments about fair value prices and has the resources available to make daily valuation determinations.

Fund directors do not abdicate their statutorily imposed responsibility to fair value securities by adopting policies and procedures that require the adviser to determine on a day to day basis the fair values of fund securities for which market quotations are not readily available. Rather, fund boards use the adviser (or other party defined in the policies and procedures) to carry out the fair value function while fulfilling the board's responsibilities to shareholders by reviewing and approving those procedures and then monitoring their implementation and ongoing effectiveness. Boards, consistent with their business judgment, should have the flexibility to use experts (whether within the organization or outside) to provide the information necessary to perform their duties with respect to fair valuation.

Just as in other areas, the board will approve the parameters of the relationship with the expert and establish a mechanism to review the expert's performance. Any guidance issued by the Commission should make clear that boards can adopt policies and procedures that require the adviser or other third party to assign values to a fund's portfolio securities consistent with their 1940 Act responsibility to fair value securities so long as the board provides effective oversight of the process.

While boards can and should be permitted to delegate their day-to-day valuation responsibilities to the fund's investment adviser, we recognize that an effective delegation requires the board to develop an understanding of the fund's policies and procedures as well as a mechanism to

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[6] The SEC staff recognized in a 1999 letter to Craig Tyle stating, "Mutual fund boards . . . typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. Most boards fulfill their obligations by reviewing and approving pricing methodologies which may be formulated by the board, but more typically are recommended and applied by fund management." Letter from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, to Craig S. Tyle, General Counsel, Investment Company Institute (December 8, 1999).

evaluate whether those policies and procedures are both being appropriately implemented and are effective. While boards should retain the flexibility to approve and implement the policies and procedures that are most appropriate for their particular funds, we believe that there are a number of broadly applicable processes that would be helpful to all boards regardless of the types of portfolio securities for which market quotations are not readily available.

As a threshold matter, boards should understand the policies and procedures regarding valuation of fund securities and the adviser's day to day process in making necessary fair valuations. An understanding of the policies does not require, however, that fund directors be familiar with the intricacies of particular fair value pricing models. As discussed above, typically the adviser is the expert with the knowledge most relevant to assigning fair values to securities. Rather, directors can be expected to understand the process that the adviser will use to value securities, particularly the identity of the parties making the determinations. Further, the board should understand how the adviser handles exceptions to the policies, including any overrides of prices received from third parties.

Boards also have the flexibility to determine how involved they would like to be in the valuation process. As the SEC staff has recognized in the past,[7] boards may choose to balance the comprehensiveness of their valuation procedures against the need for more active engagement in the process. We believe that policies do not have to list specific methodologies for every security to be fair valued to be comprehensive; rather, the policies could instead lay out factors that the adviser can consider. We understand that even boards with comprehensive policies and procedures would likely have to be more involved in the valuation process during times of extreme market stress.

The role of directors does not end with approval of the fund's policies and procedures. In fact, as in other areas where boards monitor for potential conflicts, the board's ongoing monitoring of the implementation and effectiveness of a fund's valuation policies and procedures allows the board to evaluate the adviser's process.[8]

Reports on the valuation process from the adviser are key tools in evaluating how well the valuation process is functioning. Fund boards need reports on a frequent enough basis to allow adequate monitoring of the adviser's valuation process. Further, to be useful, the reports should give the board a clear picture of the methodology used by the adviser to fair value securities and its effectiveness over time. Boards and advisers also should work together to identify when, due to changing market conditions, the typical reporting cycle may need to be augmented.

However, while ongoing monitoring and reporting are key to boards fulfilling their valuation responsibilities, boards and advisers working together should be free to choose the appropriate reports, reporting cycle, and other elements of valuation oversight that are most appropriate based on the particular facts and circumstances of each fund. Flexibility in this area will allow

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7 Id.

8 A board has many resources at its disposal to gain helpful insight into how well the fair valuation process is functioning, including the chief compliance officer and outside auditors. Boards should, however, be able to work with those parties in ways most appropriate for the particular facts and circumstances of the funds they oversee.

boards to tailor their oversight to a fund's specific investments, valuation risk issues, as well as the appropriate level of the board's engagement, in light of the many factors we have discussed above.

Through the ongoing monitoring of the fund's fair valuation processes, the board gains valuable insight into whether the fund's procedures establish a well-functioning valuation process as well as the quality of the resulting values. The process allows fund boards to identify where the procedures can be enhanced to improve the overall process. Regular review of the functioning of the fund's procedures will help boards and advisers respond to the dynamic nature of the securities markets.

IV. Conclusion

Valuation is a critically important issue for funds, fund directors and fund shareholders. I would therefore welcome the opportunity to discuss with you in more detail any of the issues discussed above or any other questions or concerns you may have about the role that independent directors play in the fair valuation process. Please call me at 202-507-4490 at any time so that we can begin this critical dialogue.

Sincerely,

Susan Ferris Wyderko
President and CEO

cc: Jennifer McHugh
David Grim
Douglas Scheidt