S7-27-03

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Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

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OFFICE OF THE SECRETARY

File Nos. S7-03-03; S7-27-03 and S7-26-03

Re: Objection to and Comment on Recently Announced Final Rule and Proposed Rulemakings Regarding Valuation of Portfolio Securities of Investment Companies

Dear Mr. Katz:

On behalf of our client, DH2, Inc., we hereby submit this objection to and comment on rulemaking File numbers S7-03-03 (Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Rel. No. IC-26299, Dec. 17, 2003) ("Compliance Rule Release");[1] S7-27-03 (Proposed Rule: Amendments to Rules Governing Pricing of Mutual Fund Shares, Rel. No. IC-26288, Dec. 11, 2003) ("Proposed Late Trading Rule Release");[2] and S7-26-03 (Proposed Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Rel. No. IC-26287, Dec. 11, 2003) ("Proposed Disclosure Rule Release").[3] DH2, a private investment manager based in Northbrook, Illinois, employs a variety of investment strategies on behalf of itself and its clients. These include, among other strategies, investment in, and active trading of, shares of mutual funds and variable insurance funding vehicles. As an investor in mutual funds and variable insurance products, DH2 has an interest in and perspective on certain new requirements adopted in the rulemaking promulgated in the Compliance Rule Release on December 17, 2003, as well as the Proposed Disclosure Rule Release and the Proposed Late Trading Release.

[1] 68 Fed. Reg. 74714 (Dec. 24, 2003) (to be codified at 17 C.F.R. pts. 270, 275 and 279).

[2] 68 Fed. Reg. 70388 (Dec. 17, 2003) (to be codified at 17 C.F.R. pt. 270).

[3] 68 Fed. Reg. 70402 (Dec. 17, 2003) (to be codified at 17 C.F.R.pts. 239 and 274).

DH2 commends the Commission and its staff for their efforts to address a number of regulatory issues critical to the protection of mutual fund investors. DH2 supports these efforts and, in large part, supports the specific regulatory steps adopted or proposed in the three Releases. In certain areas, we believe the Commission should go further to enhance the protection of investors, and our comments below address those areas. However, DH2 strongly objects to aspects of the rulemaking that conflict with the plain language of the Investment Company Act of 1940 ("1940 Act")[4] and the process by which certain requirements contained in the Compliance Rule Release were adopted in final form without providing notice to the public and an opportunity for comment.

In summary, DH2 objects that two of the Releases, the Compliance Rule Release and the Proposed Market Timing Rule Release, purport to change the requirements of Section 2(a)(41) of the 1940 Act regarding when "fair valuation" is to be applied, in a manner that conflicts with the plain language of the statute and that is at odds with the policies underlying the statute. Due to the conflict with the plain language of the statute, this aspect of the Releases is void and should be withdrawn. In addition, the Compliance Rule Release, which was promulgated as a final rule, adds substantive requirements that were not contained in the February 5, 2003 proposing release.[5] Thus the rule as adopted, to the extent that it purports to permit or require the use of "fair value pricing" when actual market prices are readily available, but "unreliable" or "stale," is invalid, because the Commission did not request or obtain public comment on this aspect of the Release. While it is understandable that the Commission wishes to respond to the fund management abuses revealed in the recent state enforcement actions and its own investigations, which were the subject of media attention and congressional hearings throughout the fall of 2003, these developments, occurring many months after the close of the comment period for the Compliance Rule, cannot be the basis for the adoption of new rules on fair valuation, which were neither discussed nor suggested in the Compliance Rule's proposing release.

Full disclosure by mutual funds and other issuers of securities is the cornerstone of the federal securities laws, including the 1940 Act. DH2 believes that the required disclosures in the Proposed Disclosure Rule Release regarding fair valuation and market timing do not go far enough to fully inform investors and allow them to make informed

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[4] 15 U.S.C. §§ 80a-1–80-a-64.

[5] Proposed Rule: Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 25925 (Feb. 5, 2003), (68 Fed. Reg. 7038 (Feb. 11, 2003) (to be codified at 17 C.F.R. pts. 270 and 275)) ("Proposed Compliance Rule Release").

judgments regarding mutual funds and variable insurance products. Additionally, DH2 believes that the compliance programs for third-party service providers adopted in the Compliance Rule Release should be extended to pricing services, in order to protect investors in mutual funds and variable insurance products.

The time-honored caution against allowing the foxes to guard the hen-house is important to keep in mind when modifying the framework under which investment company portfolio pricing is conducted. As the Commission's enforcement actions in the area of fair value pricing abuses have shown, all too often portfolio managers have intervened in the fair value pricing process—even when conducted by directors using third-party pricing services-- causing significant losses to investors. Allowing the use of "fair value pricing" when actual market prices are readily available, and doing so in a non-uniform, discretionary, and largely unregulated manner, imposes unacceptable risks on investors.

Public Comment Process Not Followed on
Portion of Final Rule Published December 17, 2003

Section 2(a)(41) of the 1940 Act states that mutual fund portfolio securities must be valued at their market prices if they are "readily available."[6] If market prices are not readily available, directors are required to determine the "fair value" of the securities.[7] The Compliance Rule Release requires directors to fair value portfolio securities if, in their judgment, market prices are "unreliable."[8] As discussed below, the Commission failed to follow the notice and comment procedures of the Administrative Procedure Act ("APA") in promulgating this substantive change in the law.[9]

Under the APA, substantive rules and amendments to substantive rules must be published for public comment, comments must be taken from the public, and those comments must be reviewed and considered, before a final rule can be promulgated.[10]

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[6] 15 U.S.C. § 80a-2(a)(41).

[7] *Id.*

[8] 68 Fed. Reg. at 74718 (Dec. 24, 2003).

[9] 5 U.S.C. §§ 500 et seq..

[10] 5 U.S.C. § 553.

Material changes to the rule between the proposing and adopting releases must be re-proposed, and comments must be re-solicited from the public, unless the change is a "logical outgrowth" of the original proposal. Moreover, rules cannot be based on undocumented assumptions and guesswork or private discussions and proceedings. Substantive rules include any agency position that purports to establish a binding requirement or obligation of general applicability, particularly one that has a direct and tangible economic impact on the regulated industry or the persons who are supposed to be protected by the relevant statutory program, regardless of whether the agency labels it as a rule.

In the Compliance Rule Release, the Commission has announced a substantive change to the requirements governing pricing of mutual fund and variable insurance portfolio assets (and thereby the purchase and redemption prices of interests in such funds) without following the notice-and-comment procedures of the APA and based upon unsupported and questionable assumptions. The Release allows or requires mutual funds and variable insurance products to be priced based not on actual market prices of the underlying assets (as required by the statute), but on "guesstimates" using "fair value pricing."[11] This change eviscerates one of the most fundamental protections of shareholders in the 1940 Act by imposing subjective pricing on interests in funds that is open to abuse and manipulation by insurance companies and fund managers.[12] This change will directly impact the pricing of purchases and sales and reporting of results of mutual funds and variable insurance products, which will have an immediate, direct, detrimental, and very tangible economic impact on investors in such funds. This stealth rule on fair value pricing buried in the adopting release accompanying the otherwise valid Compliance Rule, violates the requirements of the APA and is arbitrary and capricious and in violation of law.

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[11] We note that the term "guesstimates" was used in congressional testimony by Mr. Paul Roye, Director of the Division of Investment Management, to describe the fair valuation process that funds should undertake to address market timers who trade in international funds. *See Mutual Funds: Who's Looking Out for Investors?: Hearing Before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises of the House Comm. on Financial Services*, Cong. 108, Sess. 1, (Nov. 4, 2003) (statement by Paul Roye, Director of Investment Management, SEC (unofficial transcript, Federal New Service)). "You're trying to move in from using these stale prices, if you will, to a more accurate price, which candidly has to be some guesstimate on [the fund's] part as to what the real value of those securities are." *Id.* "[Y]ou are moving from an objective market closing price to your estimate of what you think that security is worth in light of significant market-moving events" *Id.*

[12] 1940 Act §§ 1(b)(5), 2(a)(41); 22.

The February 5, 2003 proposing release for the Compliance Rule did not mention or request comment on fair valuation or market timing, and no comments were submitted addressing these issues. While the release briefly mentions pricing of portfolio securities and fund shares in the nonexclusive list of subjects that should be addressed in fund policies and procedures,[13] there is no suggestion that the proposed Compliance Rule is intended to permit or require fund boards to fair value portfolio securities when market prices are available, but "unreliable" or "stale" and no suggestion that the Rule is intended to require that fair valuation be used as a means to address "market timing" or active trading of mutual fund shares. Moreover, by its terms, the proposing release merely proposed to require policies and procedures reasonably designed to assure funds' compliance with the securities laws and did not purport to establish, refine, or change the underlying substantive laws applicable to mutual funds and variable insurance contracts. In the public comments included in the Commission's rulemaking docket, only one commenter mentioned market timing (the Financial Planning Association), and the comment was made in a context entirely different from fair valuation of fund portfolios and not relevant to the issue at hand.[14] None of the comment letters addressed fair value pricing.

The Compliance Rule, Rule 38a-1, as adopted, contains no reference in the rule text to fair valuation.[15] However the text and footnotes of the Compliance Rule Release requires that mutual funds and insurance companies implement compliance policies and procedures to assure that fair valuation is substituted for actual market prices when actual market prices are "unreliable."[16] In his formal written remarks to the Commission at the December 3, 2003 open meeting at which the Compliance Rule was discussed, Division Director Paul Roye described the new rule as requiring that "[f]unds must adopt fair value pricing procedures designed to eliminate the time zone arbitrage

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[13] 68 Fed. Reg. at 7041 (February 11, 2003). In a footnote to this provision, the Release cites Rule 2a-7(c)(7) under the Investment Company Act, which requires boards of money market funds to establish written procedures reasonably designed . . . to stabilize the money market fund's net asset value per share. *Id.* n. 32.

[14] Letter from Duane R. Thompson, Director of Government Relations, Financial Planning Asso., to Jonathan G. Katz, Secretary, SEC (Apr. 17, 2002) (available at http://www.sec.gov/rules/proposed/s70303/fpa041703.htm).

[15] 17 C.F.R. § 270.38a-1.

[16] 68 Fed. Reg. at 74718 (Dec. 24, 2003).

opportunities...."[17] The language in the Release accompanying the Compliance Rule itself purports to impose a binding, substantive requirement that changes the valuation methodology dictated by statute, with an impact on thousands of mutual funds and variable insurance funds and millions of investors. Whether styled as rules or not, agency statements that should be subject to the notice-and-comment rulemaking requirements of the APA are invalid and unenforceable if the agency does not follow the process.[18]

The notice-and-comment requirements of the APA cannot be evaded by placing substantive legal requirements in the text of an adopting release. Whether the release is considered a part of the final rule, or is itself a free-standing pronouncement of the Commission, it purports to mandate a change in portfolio valuation methodologies with a large impact on the investing public, mutual funds, and insurance companies. As such, it is is invalid unless it is adopted through the full notice-and-comment procedures of the APA.[19]

Because no mention of a proposed requirement to "fair value" assets when market prices are available but "unreliable" was contained in or suggested by the Proposed Compliance Rule Release, and this requirement is not a "logical outgrowth" of the Proposed Release, this aspect of the release is void and of no effect unless and until it is re-proposed, public comments are re-solicited, and consideration is given to those

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[17] Paul Roye, Director, Division of Investment Management, Opening Statement at Open Commission Meeting,(Dec. 3, 2003), at p. 6 *available at* http://www.sec.gov/news/speech/spch120303pfr.htm). To further underscore the binding obligation imposed by the Release accompanying the adoption of Rule 38a-1, the separate Proposed Disclosure Rule Release proposing the amendments of the fund disclosure forms describes the obligations imposed by the Compliance Rule Release to fair value securities when actual market prices are available but "unreliable." Rel. IC-26287 at pp 4, 12-13, fn. 51 (Dec. 11, 2003) (68 Fed. Reg. at 70403, 70408 (Dec. 17, 2003)). "We are proposing to amend this instruction to clearly reflect that funds are required to use fair value prices any time that market quotations for their portfolio securities are not readily available (including when they are not reliable)." *Id.* at 70408.

[18] *See, e.g., Cerro Metal Products v. Marshall*, 620 F.2d 964, 981-82 (3rd Cir. 1980) (holding that OSHA could not make binding change in the challenged regulation without providing opportunities for notice and comment); *Joseph v. United States Civil Service Comm'n*, 554 F.2d 1140, 1153-54 (D.C. Cir. 1977) (holding Civil Service Commission's application of the Hatch Act to District of Columbia elections a legislative rule requiring compliance with the APA)..

[19] *See Phillips Petroleum Co. v. Johnson*, 22 F.3rd 616 (5th Cir. 1994), *cert. denied*, 514 U.S. 1092 (1995) (change dictated by internal agency document to pricing methodology used by federal government agency to value oil and gas royalties was a substantive rule for which publication, notice, and comment was required under APA).

comments by the Commission, through an appropriate notice-and-comment process under the APA.[20]

At the end of this letter, we discuss our specific substantive concerns relating to the fair valuation process and identify the types of issues and alternatives we believe an appropriate rulemaking proceeding will be able to address. We emphasize that the valuation of portfolio securities is one of the fundamental investor protection concerns of the 1940 Act – so fundamental that it is one of the few tasks specifically delegated by statute to fund directors. We do not believe the statutory directive as to those limited circumstances in which market prices may be abandoned and directors may substitute their good faith "guesstimate" can or should be amended in the indirect manner the Commission chose in the Compliance Rule Release.

Conflict With Plain Language of Statute

Following the APA procedural requirements will not, however, cure a fundamental defect in the "fair value" requirement as set forth in the Releases. Commission Releases that allow or require mutual funds and variable insurance separate accounts to ignore actual market prices and instead use the "guesstimate" methods of fair valuation pricing when actual trading market prices are readily available, conflict with the plain language of the statute and are void.

Use of unsound, subjective pricing methodologies was one of the principal abuses in the investment company industry that the 1940 Act was designed to eliminate.[21] The Act requires the use of actual market prices when they are available, in order to reduce the use of subjective valuation methods and the resulting risks to investors due to fraud and error in calculating share prices and portfolio values.

Section 2(a)(41) of the 1940 Act specifies exactly when fair value pricing is to be employed, and who must conduct it when it is used. Fair value pricing is only to be used when actual market prices are not "readily available." The Compliance Rule Release and the Proposed Disclosure Rule Release purport to restate the statutory language as "not

[20] *See, e.g., Spirit of the Sage Council v. Norton*, No. CIV.A.98-1873, 2003 WL 22927492 * 17-18 ((D.D.C. Dec. 11, 2003) (several rules issued under the Endangered Species Act were not a logical outgrowth of prior agency notice).

[21] 1940 Act §§ 1(b)(5); 2(a)(41), 22.

readily available *or unreliable*."[22] In the December 3, 2003 open meeting of the Commission, the Staff stated that fair value pricing is required to be used under the new rule when market prices are not readily available, *unreliable* or *stale*.[23] This simply is not the law, and it never has been.

The two Releases refer to an April 2001 Staff letter to support the proposition that fair valuation can be applied when actual market prices are readily available but a few hours old, such as from international markets. Yet, soon after the Commission Staff issued the April 30, 2001 Letter, the senior Commission Staff member who authored the letter readily acknowledged that the analysis in the letter was not consistent with the language of Section 2(a)(41) of the Act. "[T]he actual wording of the statute won't lead you to the conclusion that we came to. The statute says when market quotations are readily available, you use the market price. Well, when Asian markets close 12 hours before the funds calculate their NAV at 4:00 p.m., you might reasonably or so conclude that those market prices are readily available and you would use them."[24] "The difficulty with the position in the letter is that it runs up against what the statute says. The statute says if market quotations are readily available, then you use them. The question is what is a readily available market price? When a foreign market closes 12 to 15 hours before the fund calculates its NAV, you could guess that the market quotations are readily available, they're right there, they are there for you to use."[25] "Now it may be a remarkable proposition because if you look to the words of the statute and you'd say readily available market quotations, and you look at your closing prices on the foreign exchange you'd say, well they're readily available aren't they?"[26]

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[22] 68 Fed. Reg. at 70418 (Dec. 24, 2003); 68 Fed. Reg. at 70403 (Dec. 17, 2003). (emphasis added)

[23] *See* Roye at p. 6; Recording of Dec. 3, 2003 Open Meeting of the Commission (available on Commission Website).

[24] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* at p. 4, (New York, June 13, 2001) (remarks of Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

[25] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* at p. 6 (Boston, June 13, 2001) (remarks of Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

[26] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* at p. 5 (Chicago, June 7, 2001) (remarks of Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

As the Investment Company Institute ("ICI") has noted, "the 1940 Act does not permit funds to use fair values unless market quotations are not 'readily available.' The existence of any particular market timing strategy involving a fund does not necessarily call into question the ready availability of market quotations for that fund's portfolio securities."[27]

When Congress enacted Section 2(a)(41) as part of the 1940 Act, it had been the practice to use yesterday's market closing prices to establish today's purchase and redemption prices for investment company shares. The current system of "forward pricing," or using same-day closing prices to process purchase and redemption orders, was not adopted until 1968 (a change made by a formal notice-and-comment rulemaking conducted by the Commission).[28]

In 1940, market closing prices that were twenty-four hours old (or seventy-two hours old in the case of a Monday or ninety-six hours old after a three-day weekend) were nonetheless considered "readily available" for the purpose of valuing a fund. Congress clearly was aware of the potential for investor arbitrage in placement of purchase and redemption orders and consequent dilution of share values,[29] but evidently Congress viewed insiders' use of discretionary valuation and pricing as a greater risk to investors than the potential dilution from pricing arbitrage by some investors. Congress chose to reduce but not eliminate dilution risk by requiring use of recent actual market prices—albeit prices that are a day or more stale—to value portfolio assets, rather than to allow insiders to set valuations at their discretion.[30]

When a rule or agency interpretation conflicts with the plain language of the statute, it is void and of no effect.[31] "When Congress establishes the rules, an agency

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[27] ICI, VALUATION AND LIQUIDITY ISSUES FOR MUTUAL FUNDS at p. 7 (Mar. 2002 Supplement).

[28] Investment Company Act Release No. 5413 (June 25, 1968), SEC Investment Company Act Release No. 5519 (Oct. 16, 1968).

[29] *United States v. National Ass'n of Securities Dealers*, 422 U.S. 694, 706-10 (1975) (quoting extensively from legislative history of the Act).

[30] *See id.* at 709 (quoting Investment Company Act § 22(a)).

[31] *See Board of Governors of the Federal Reserve System v. Dimension Financial Corp.*, 474 U.S. 361 (1986) (holding Federal Reserve Board's definition of a bank in conflict with the language of the Bank Holding Act); *American Bankers Ass'n v. Securities and Exchange Comm'n*, 804 F.2d 739 (D.C. Cir. 1986) (SEC's attempt to regulate banks as broker-dealers held in violation of the authority granted the Commission under the Securities Exchange Act of 1934.).

must carry them out. A desire to keep the law 'up to date' does not justify departure from its rules."[32] Here, the Commission's statement, set forth in two of the December 2003 Releases, that fair value pricing is to be applied when actual market prices are "unreliable," rather than limited to circumstances when they are "not readily available," conflicts with the plain language of Section 2(a)(41) of the 1940 Act, and is therefore void and of no effect. Accordingly, those portions of the two December Releases that purport to allow or require use of "fair value pricing" when actual market prices are available, but a few hours old, or deemed to be "unreliable," should be withdrawn formally by the Commission.

Other Comments

The Commission should not take from the objection and comments set forth above that our client, DH2, is opposed to most of what is contained in the two proposed rules or the final rule announced in the December Releases. Most of what is contained in the Releases is appropriate and an important addition to the framework of regulation of investment companies, to which we have no objection. Other portions of the regulatory program set forth in the Releases, while well-intentioned, contain significant gaps and shortfalls that compound the risks posed by allowing or requiring mutual funds and insurance companies to fair value fund assets under a broader set of circumstances than the statute currently permits. As a result, we think that in some respects the proposals and the final rule announced in the December 2003 Releases do not go far enough. Some of the more significant issues in this category are as follows.

Reemphasize the Role of Investment Company Directors in Conducting Fair Valuations

Section 2(a)(41) of the 1940 Act specifically requires that directors conduct fair valuations. There appears to be widespread reluctance, or inability, on the part of directors to fully perform this role.[33] As noted by one experienced counsel to independent directors of mutual funds:

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[32] *See Board of Trade of the City of Chicago v. Securities and Exchange Comm'n*, 883 F.2d 525, 535 (7th Cir. 1989) (citation omitted).

[33] See *The Role of Independent Investment Company Directors: Transcript of SEC Conference on the Role of Independent Investment Company Directors* at p. 86 (Feb, 23 & 24 1999)(Statement of Manuel Johnson, former Vice Chairman of Federal Reserve Board and independent director of Dean Witter funds).

Footnote continued on next page

> [W]hat the independent directors that we represent are doing, most of them are sort of throwing up their hands as they typically do with pricing issues and saying to the advisor to the fund, get back to us and give us some guidance or explain what your current policies and procedures are, and explain what you're going to do to respond to this [April 30, 2001 SEC Staff] letter. And I think that's been unilaterally the response from directors. They're all scared of pricing issues generally and they're looking to the advisor to the fund complex to give guidance on this issue and explain what it is that they're going to do to make sure they're in compliance with the requirements imposed by the Letter.[34]

The Compliance Rule Release and other Commission actions and statements should reinforce to directors the importance of their role in the pricing function and their obligation to participate directly in the conduct and supervision of fair valuations. The Commission should provide more specific direction regarding the steps that directors must perform under Section 2(a)(41) of the 1940 Act, in those narrow contexts where fair valuation is conducted.

Compliance Programs Should Be Extended to Pricing Services

New Rule 38a-1(a)(1) and the Compliance Rule Release at footnote 28 require investment companies and insurance company separate accounts to adopt compliance policies and procedures to cover outside service providers but conspicuously omit pricing services from this requirement. Yet, as the Commission is aware, pricing services can be a participant in or a cause of violations of the 1940 Act, particularly in the context of fair value pricing.[35]

The involvement of a pricing service in this type of violation can hardly have come as a surprise. The Commission Staff has long been acutely aware of the dangers of

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[34] *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (New York, June 13, 2001) at p. 8 (remarks of James Anderson, Esq., partner at Wilmer, Cutler & Pickering).

[35] *See In the Matter of FT Interactive Data f/k/a Interactive Data Corporation*, Rel. No. IC-26291 (Dec. 11, 2003) (enforcement action against pricing service for causing and willfully aiding and abetting a violation of the Act in the fair valuation of fund portfolios).

delegation of this function to a third-party pricing service. As noted by the author of the April 30, 2001 Letter: "[t]he other thing I've tried to warn people about is – and trustees – is that they should know that sometimes the pricing services just spit back what the funds tell them the price should be, or the portfolio manager will tell them what the price should be."[36] "[S]ometimes, though, what the pricing service is providing you is basically what the portfolio manager gave to the pricing service and the pricing service is just spitting that back. It's not really using any judgment; it's not providing an independent, if you will, valuation, but it's merely spitting back what the portfolio manager gave."[37]

Other obvious risks from allowing unsupervised and unregulated services to conduct a critical function such as fair valuation include the risk that access persons of the pricing service will use their insider knowledge of the secret valuation methodology to engage in precisely the same insider abuses and market timing that triggered New York Attorney General Spitzer's and the Commission's investigations and this set of rule makings, as well as the risk that unsupervised and unregulated pricing services will conduct fair valuations in a negligent manner.

As regards the first point, the trust that the Commission has for years accorded the mutual fund industry and its services providers has been shown by recent events to have been misplaced. Insiders were actively involved in the current scandals. As a good example of this risk, we note that Assistant Professor Zitzewitz, who was liberally cited as an expert by government officials and the press, has admitted that he was engaged in market timing with a large sum of money at a time when he was assisting the government's inquiry and working with FT Interactive Data to design, conduct, and sell fair value pricing programs to mutual funds. When questioned by the press on the propriety of engaging in market timing when he had access to the inner workings of a pricing service retained to conduct fair value pricing of mutual funds, Mr. Zitzewitz stated that he was not a fiduciary of the mutual funds and thus not precluded from using his knowledge of pricing anomalies to engage in market timing.[38] His conduct demonstrates the obvious need to supervise pricing services.

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[36] *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (Boston, June 13, 2001) at p. 22 (remarks of Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

[37] *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (New York, June 13, 2001) at p. 13 (remarks of Douglas Scheidt, Assistant Director, SEC Division of Investment Management).

[38] Randall Smith, *Of Good Timing And Bad Timing And Prof. Zitzewitz,* WALL ST. J., Dec. 9, 2003, at C1.

Another risk is posed by the limited liability enjoyed by pricing services. The 1940 Act does not specify or impose any particular standard of care upon pricing services or regulate them in any way. Service contracts between pricing services and mutual funds commonly purport to relieve the pricing service from liability if there is a problem. Because the Commission appears to be willing to allow fund directors to satisfy their statutory responsibility to conduct fair valuations by delegating this function to pricing services, and the pricing services are not being held to account for anything short of willfully causing violations of the 1940 Act, investors are exposed to risk from the unsupervised activities of an unregulated pricing industry.

In light of the specific requirement in Section 2(a)(41) of the 1940 Act that the directors of the fund conduct any fair valuations, and the substantial risk of abuse and loss to shareholders when directors delegate this responsibility to unsupervised pricing services, Rule 38a-1 should be extended to require funds to adopt compliance policies and procedures regarding pricing services. Failure to include compliance policies covering pricing services within Rule 38a-1, particularly in the context of a Release that purports to greatly expand the use of fair value pricing, is arbitrary and capricious. We respectfully urge that Rule 38a-1 be amended to include pricing services within the list of services providers as to which the board of a mutual fund must adopt policies and procedures and exercise oversight.

Moreover, allowing such a critical function to be performed by pricing services that are not subject to regulation and inspection by the Commission is a serious gap in the protection of mutual fund investors. Independent data processors for banks are subject to regulation, examination, and the administrative enforcement framework of the federal banking laws.[39] We see no reason the Commission should not seek from Congress, and exercise, similar authority over third-party pricing services to investment companies and insurance company separate accounts.

Disclosure Proposal Should Be Expanded to Better Inform Investors

Transparency in the pricing process—including the fair valuation process—is extremely important to protecting investors from insider abuses. The proposed requirement set forth in the Proposed Disclosure Rule Release,[40] regarding disclosures of

[39] *See* 12 U.S.C. § 1867(c).

[40] Release No. IC-26287 (Dec. 11, 2003); 68 Fed. Reg. at 70402 (Dec. 17, 2003).

policies relating to fair value pricing and active trading in Forms N-1A, N-3, N-4 and N-6, is a start—it recognizes this is information that is material to investors—but it does not go far enough in the required disclosures. The Release contains a good discussion of required disclosures for policies on active trading, including a precise description of what specific restrictions are imposed, what types of active trading is permitted, and what specifically are prohibited. The required disclosures should also include a discussion of the potential costs and burdens on shareholders of the restrictions, why they were adopted, and a detailed, factual discussion of the actual cost savings (if any) that shareholders will receive from allowing the mutual fund to have such restrictions. Disclosure of fair valuation policies and practices should cover not only the fact that fair valuation is or is not used, the circumstances under which fair valuation will be used, and the effects of fair value pricing—it should also describe why fair valuation is used, who actually conducts the fair valuation, what exact methods and calculation methodologies are used to conduct fair valuation, the impact fair valuation has on investors, performance information and portfolio values of fair valuations, a discussion by the board of why it is using fair valuation (and why the board selected the particular methods and vendors), the risks of fair value pricing, fair value errors that have been made by the fund, and the internal supervisory procedures, auditing requirements, board oversight, and other internal controls that are in place to control fair value pricing process.

The Late Trading Proposal

DH2 notes that the proposed rule in the form set forth in the Proposed Late Trading Release captioned "Amendments to Rules Governing Pricing of Mutual Fund Shares,"[41] unlike the other two December Releases, does not appear intended to address fair value pricing or seek to expand the circumstances under which fair value pricing is used. The Late Trading Release describes the statutory requirement on fair value pricing as follows: "[A] fund's NAV generally reflects the closing prices it holds. For securities that are not listed on exchanges or for which there are otherwise no readily available market values, a fund's board of directors must establish a fair value for the securities."[42] To the extent, however, that the final rule or the release accompanying it is changed from the proposal or is read to include in some fashion an expansion of the circumstances under which "fair value pricing" is permitted or required, we would object.

[41] Release No. IC-26288 (Dec. 11, 2003); 68 Fed. Reg. at 70388 (Dec. 17, 2003).

[42] Rel. IC-26288 fn 4; 68 Fed. Reg. at 70388.

We also note that the Releases acknowledge that "[m]arket timing itself is not illegal"[43] and that the Releases do not purport to make market timing illegal.

Valuation Issues Should be Carefully Studied and Appropriate Solutions Analyzed and Considered as Part of Rulemaking Process

The purpose of conducting a rulemaking under a notice-and-comment process is to gather and analyze and variety of views on a topic and proposal. Based upon statements made by the Commission Staff, it appears that the Staff and the Commission have relied almost exclusively on a private dialog with representatives of the mutual fund industry in developing the position on fair value pricing that is stated in the Compliance Rule Release and the proposed Disclosure Rule Release.

The Compliance Rule Release describes a Commission Staff Letter from April 2001 regarding use of fair value that was issued to the ICI. This letter, however, suffers from the same basic flaw of conflicting with the plain language of Section 2(a)(41) of the Act and not having been proposed and adopted under the APA. Moreover, at the time the April 2001 Letter was issued, the Commission was under a rulemaking moratorium, under which only routine, non-controversial rules could issue.[44] Thus, since the SEC would not have been permitted to adopt the new position at that time as regulations, it appears the letter may have been issued as a Staff Letter to address what the Staff believed was an important policy issue in an manner that avoided the rulemaking moratorium. The Staff Letter, therefore, cannot be deemed to have the force of a Commission rule, since it would have been in violation of the moratorium as well as the notice-and-comment provisions of the APA when the 2001 letter was issued. The Compliance Rule Release appears to seek retroactively to cure that defect by discussing the position stated in the Compliance Rule Release and the proposed Disclosure Rule Release as though it were settled law.

Questions were raised at the time the Staff letter was issued as to whether a change in interpretation of this significance could be adopted by Staff by private letter, rather than by the notice-and-comment process required under the APA for substantive

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[43] Rel. IC-26287 § I-A; 68 Fed. Reg. at 70404.

[44] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* (Chicago, June 7, 2001) at p. 2; (Boston, June 13, 2001) at p. 3; (New York, June 13, 2001) at p. 3 (remarks of Douglas Scheidt).

changes in rules. As reflected in the Staff's comments below, the Commission Staff apparently did not give the APA requirements consideration and instead relied entirely on private discussions with the mutual fund industry.

J.O. [John O'Hanlon] One of the advantages of a rulemaking process is that the Commission gets the benefit of views of the industry and the people who are actually doing this day to day. And, you know, things like costs and benefits are taken into account. And Doug, I'm just curious, was there any discussion given to whether it would be appropriate to do this type of – provide this type of guidance in a rulemaking context?

D.S. [Douglas Scheidt] Actually, there wasn't. And if we are merely doing what we think is interpreting the law, we don't feel that there's any legal obligation to seek comment from the public and publish, you know, the proposed action for comment under the Administrative Procedure Act.

I can tell you what we did, though, We were concerned about the effect of the position – of taking this – or reminding people of this position, and we met with the representatives of the Investment Company Institute, and we said "This is what we propose to do. What kind of impact do you think it would – do you agree, do you disagree, what kind of impact do you think it would have?" And the ICI told us that they agreed with our position. They said it's the right thing. And in fact, they pointed to—I don't know, most of you probably have seen the ICI's white paper on valuation. It was issued in 1997. There is a discussion in that section that basically reflects what the letter says on fair valuing foreign securities' stale prices. So we did some homework, or we did some reaching out to talk to one of the major representatives of the industry and got its reaction.[45]

[45] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* at pp. 10-11, (Boston, June 13, 2001) (question of John O'Hanlon, Esq. Dechert and response of Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

This private dialog between the Commission Staff and the ICI has continued over several years and well into the rulemaking period. On October 16, 2003, Paul Roye, the Director of the SEC's Division of Investment Management made the following statements:

> The staff has been working with the [mutual fund] industry to address the negative impact of market timing on long-term shareholders. Last year, the staff issued an interpretive letter permitting funds to provide for delayed exchanges of shares from one fund to another in order to combat market timing. In addition, in a letter issued in 2001, the staff clarified funds' obligations to fair value their portfolio securities, including international securities, if a significant event occurs between the time that a security's closing price on an exchange is established and the time that the fund calculates its NAV. ... In 2001, the staff reminded the fund industry of funds' obligation to fair value their holdings under certain circumstances.[46]

On November 3, 2003 Division Director Roye made similar statements in his testimony before the Senate Subcommittee on Financial Management, the Budget and International Security:

> The staff has been working with the mutual fund industry to address the negative impact of market timing on long-term shareholders. Last year, the staff issued an interpretive letter permitting funds to provide for delayed exchanges of shares from one fund to another in order to combat market timing. ... [I]n a letter issued in 2001, the staff clarified funds' obligations to fair value their portfolio securities, including international securities, if a significant event occurs between the time that a security's closing price on an exchange is established and the time that the fund calculates its NAV. [47].

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[46] Paul Roye, Director, SEC Division of Investment Management, ALI-ABA Seminar: Investment Management Regulation (Oct. 16, 2003) (avail. on Commission website) (emphasis added).

[47] *Mutual Funds: Trading Practices and Abuses that Harm Investors: Hearing Before the Subcommittee on Financial Management, the Budget, and International Security of the Senate Committee on Governmental Affairs*, Cong. 108, Sess. 1 (Nov. 3, 2003) (written statement of Paul Roye, Director, Division of Investment Management) (emphasis added).

The Commission has adopted in the Compliance Rule Release a rule on a significant valuation issue that affects all mutual fund shareholders and variable insurance contract holders, without any public process. The Commission has engaged in a long and extensive private dialog with the ICI and representatives of the regulated industry on which it has based this rule, and yet has failed to allow the general public in on the debate over when and under what circumstances mutual fund directors should be allowed or required to abandon actual market prices in valuing the portfolio securities of mutual funds.

The Compliance Rule Release, like the April 30, 2001 Staff Letter, represents a significant departure from prior Commission policy and interpretation of the 1940 Act. As one knowledgeable observer put it:

> I think the bulk of the industry views [the position described in the April 2001 letter] as a significant change of policy in that you can no longer rely on the last-quoted price for a security on an exchange in making a fair value determination. ... I do think a number of us in the industry view it as a bit of a sea change.[48]

The Staff Member who wrote the April 30, 2001 Letter conceded that:

> I think that it is perhaps viewed as an expansion in one respect. To the extent that market volatility is deemed to be a significant event for purposes of the letter, then, my understanding is that that's a new concept to some people. That's one reason why we included in the example to the letter, there are two pages of examples at the end, to show how market volatility can cause dilution and how market volatility can sometimes constitute a significant event. I don't think it was necessarily a new concept that a corporate action that occurred between the close of the Tokyo Stock Exchange and the fund's calculation of new asset value as of 4:00 p.m., I don't think that was a surprise to people that that might constitute a significant event that would require fair valuation. So, I'll

[48] *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (New York, June 13, 2001) at pp. 4, 8 (remarks of Elizabeth Krentzman, National Director, Regulatory Consulting, Deloitte & Touche, and former senior staff member at SEC Division of Investment Management).

grant you that. Market volatility may be a new concept as far as significant events go.[49]

The Staff member who wrote the letter initially justified the issuance of the April 2001 Letter on the theory that it was merely a restatement of a long-standing SEC position, reflected in a footnote to a 1984 rulemaking proposal on another topic. When pressed on the issue at a seminar conducted for mutual fund directors to discuss the letters, however, he readily conceded that the April 2001 Letter's indication that market volatility and changes in general market trading prices after the close of a foreign securities market are "significant events" mandating the use of fair valuation was "novel." He did not seek to defend the claim that it originated in a footnote to a 1984 rulemaking proposal, a concession that drew laughter from the panel and an audience of industry insiders.[50]

Under the APA, substantive changes in the law and the way in which it is applied by an agency are supposed to be made by a formal, public, notice and comment rulemaking process, with the decision reached by the agency heads, rather than by interpretations issued *ex parte* by the staff.[51]

There is a reason that we have an APA. It is to force into the sunshine the federal agency process for deciding major legal and policy matters of general applicability and to place proposed changes in such policies into the public forum, so that all views will be carefully considered. Rulemakings and major policy decisions arrived at by private dialog between representatives from the regulated industry and SEC staff members, many of whom have spent much of their careers prior to joining the agency as employees or lawyers for the industry, are unlikely to reach a fairly-considered result that incorporates all available information and views. Opening up the process to the public results in a more careful process and ultimately a better rulemaking. The notice-and-comment rulemaking process is designed to "reintroduce public participation and fairness to

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[49] *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (Chicago, June 7, 2001) at p. 8 (remarks of Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management).

[50] *Transcript of Directors Roundtable Seminar on Fair Value Pricing* (Chicago June 7, 2001) at pp. 8, 10-11 (discussion between David Sturms, Esq. of Vedder, Price and Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management).

[51] 5 U.S.C. § 551 et seq.; *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979); *Cubanski v. Heckler*, 781 F.2d 1421 (9th Cir. 1986); *Brown Express, Inc. v. United States*, 607 F.2d 695, 702 (5th Cir. 1979); *Pacific Gas & Electric, Co. v. Fed Power Comm'n*, 506 F.2d 33, 37-38 (D.C. Cir. 1974).

affected parties after governmental authority has been delegated to unrepresentative agencies,"[52] and to "enable the agency promulgating the rule to educate itself,"[53] before the agency position becomes "chiseled into bureaucratic stone."[54]

In the words of the United States Court of Appeals for the Fifth Circuit:

> The Supreme Court has stated that the notice and comment provisions "were designed to assure fairness and mature consideration of rules of general application." *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 764, 89 S.Ct. 1426, 1429, 22 L.Ed.2d 709 (1969). These provisions afford an opportunity for "the agency promulgating the rule to educate itself before establishing rules and procedures which have a substantial impact on those regulated." *Texaco, Inc. v. Federal Power Comm'n*, 412 F.2d 740, 744 (3rd Cir. 1969). Congress realized that an agency's judgment would only be as good as the information upon which it drew. It prescribed these procedures to ensure that the broadest base of information would be provided to the agency by those most interested and perhaps best informed on the subject of the rulemaking at hand. *See Shell Oil v. Federal Energy Admin.*, 574 F.2d 512, 516 (Temp. Emer. Ct. App. 1978).[55]

The flaws in the process are not simply a technicality. Rather, in the case of the fair valuation provisions of the Compliance Rule Release, these process flaws have resulted in major changes being made without any consideration of the nature of the problem that needs to be addressed, all of the alternatives, all of the pros and cons, how best to implement the selected alternative, and all of the unintended consequences of the change. In contrast to the open, public, process-driven mechanism by which laws and regulations are amended and major policy decisions that affect millions of people should be made, privately-made rules and policy decisions that affect the general public are often faulty and ill-considered, precisely because they are made in haste without consideration of all of the data and input from all affected parties.

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[52] *See Batterton v. Marshall*, 648 F.2d 694, 703 (D.C. Cir. 1980)

[53] *See Texaco, Inc. v. Fed. Power Comm'n*, 412 F.2d 740, 744 (3rd Cir. 1969).

[54] *See American Fed'n of Gov'tt Employees v. Block*, 655 F.2d 1153, 1157 (D.C. Cir. 1981).

[55] *See Phillips Petroleum*, 22 F.3d at 620.

For example, the Commission has simply assumed—based largely on wildly divergent estimates by two professors in the employ of pricing services that sell fair value pricing to mutual funds—that the actions of "market timers" who invest in mutual funds that own foreign exchange-traded securities present a serious problem of shareholder dilution, and allow risk-free arbitrage opportunities for the market timers. The Staff in the April 30, 2001 Letter "demonstrated" the problem with an elaborate hypothetical example showing the dilution and risk free arbitrage opportunities.

But even the ICI stated that the SEC Staff's example was suspect and did not justify the use of fair value pricing. In its March 2002 memorandum on "Valuation and Liquidity Issues for Mutual Funds," (which updated the ICI's 1997 memorandum on the same topic) the ICI discusses the April 2001 SEC Letter at length and states that the SEC's "example makes a number of assumptions that are unlikely to apply in many instances" including a major after-hours shift of more than 10% in securities traded on a foreign market as evidenced by subsequent trading in the U.S., a market timing transaction that is over 22% of the aggregate size of the mutual fund involved, and that the foreign market closes the next day in perfect correlation to the U.S. close. According to the ICI, each of these events is highly unlikely to occur; and in combination as used in the SEC's hypothetical to justify the April 2001 Letter, they are an unrealistic set of assumptions on which to base a major legal and policy shift.[56] According to the ICI, "nothing in the [SEC's April 30] 2001 letter warrants a conclusion that the elimination of arbitrage and the dilution that can result is an appropriate reason, in and of itself, to fair value portfolio securities."[57]

In addition, the Commission appears to have failed to consider whether other readily available alternatives, that do not require departure from actual market pricing, would be sufficient to address market timing concerns.

Moreover, it appears that the Commission has not considered whether there is a best way to go about fair valuation of foreign exchange-traded securities to bring them forward to a 4 p.m. EST valuation, or even determine exactly when fair valuation should be used in this context. The Compliance Rule Release purports to impose fair valuation as a binding obligation, yet this obligation is imposed in such an amorphous and vague way it will be impossible for investment companies and their shareholders to know

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[56] ICI, VALUATION AND LIQUIDITY ISSUES FOR MUTUAL FUNDS at p. 7 (Mar. 2002 Supplement).

[57] *Id.*

whether this new obligation is being met. This is a major daily issue affecting thousands of funds and millions of shareholders that the Commission has not given adequate consideration or defined in any way before purporting to impose this new requirement on mutual funds and variable insurance funding vehicles and their shareholders and policyholders. Different fair valuation methodologies can result in widely divergent results, all of which may result in arbitrary adjustments to portfolio valuations.

There is nothing in the record showing that the Commission considered the consequences of its action—that by moving to a subjective fair value process, it is removing one of the most important checks on portfolio managers in the 1940 Act and imposing on independent directors a complex and subjective task that they are ill-equipped to perform properly.[58] Nor does there appear to have been any deliberations by the Commission as to the significant difficulties faced by external auditors of mutual funds or the Commission's own examination and enforcement staff in trying to police a subjective fair valuation standard.[59]

Thus, the Commission's failure to follow the notice-and-comment process of APA rulemaking is not simply a technical oversight. It has resulted in a rulemaking in which the Commission did not consider all of the alternatives, the pros and cons of each, the many ripple effects of the new position, and the processes that will need to be created to replace market pricing in order to keep the fair valuation process from becoming next year's financial scandal. The deliberations were conducted in secret between the Commission Staff and the mutual fund industry, without input from shareholders or the general public.

To date, the Commission has relied on the mutual fund industry, and "experts" in the employ of vendors of pricing services to the industry for its information and

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[58] *See, e.g., The Role of Independent Investment Company Directors: Transcript of SEC Conference on the Role of Independent Investment Company Directors* at p. 86 (Feb. 23 & 24, 1999) (statement of Manuel Johnson, former Vice Chairman of Federal Reserve System and independent director of Dean Witter funds); *Transcript of Directors Roundtable, Fair Value Pricing Seminar* (New York, June 13, 2001) at p. 8 (remarks of James Anderson, Esq. partner at Wilmer, Cutler & Pickering).

[59] *See, e.g., In the Matter of Piper Capital Management, Inc. et al.*, SEC Docket 2525 (Nov. 30, 2000) (Staff of Enforcement Division stating that fair valuation issues are among the most complex and time consuming enforcement issues).

analysis.[60] The "experts," cited by the SEC, differ by a large amount in their assessment of the impact of market timing (Zitzewitz finds an impact that is 2 ½ times as large as that found by the other professor cited by the Commission,[61] and larger by a factor of 100 than those found by other academics).[62] The Commission should conduct its own study, and gather real information from the public and a variety of sources, rather than simply rely on persons with an obvious salesman's stake in requiring broader use of "fair value pricing." A broader and more searching economic analysis that does not simply rely on guesswork, industry-supplied experts, and unsupported assumptions is both important and necessary to address these issues.

Professor Henry Manne, in a commentary published January 8, 2004 in the *Wall Street Journal*, excoriated both the academics upon which the Commission has relied and those conducting the matter for the government agencies for their sloppy analysis and rush to judgment.

> The economic justification for much of Mr. Spitzer's claims rests squarely on a recent, widely cited academic paper, "Who Cares About Shareholders? Arbitrage-Proofing Mutual Funds," by Prof. Eric Zitzewitz of the Stanford Graduate School of Business. This paper purports to show that the various late-trading or market-timing schemes are costing long-term investors in American mutual funds about $4.9 billion a year. The problem is that the paper demonstrated no such thing.
>
> After explicitly acknowledging that there was no direct way of measuring the dilution of long-term fund investors' interests, Mr. Zitzewitz estimated the maximum amount that arbitrageurs or short-term traders could theoretically make from such trading. He then simply assumed that the long-term investors had lost that much in dilution of their shares. But he took no account of individuals' and funds' responses to the behavior under

[60] Assistant Professor Zitzewitz is a paid consultant to FT Interactive Data, a major third-party provider of fair value pricing services to mutual funds. Professor Goetzmann is a paid consultant to ITG, Inc., also a major third-party provider of fair value pricing services to mutual funds. Each professor is prominently featured on the website of the respective fair value pricing service and has appeared at various promotional seminars for the services. *See* www.itginc.com; www.ftinteractivedata.com.

[61] *See Proposed Disclosure Rule Release*, Rel. No. IC-26287, fn.13; 68 Fed. Reg. at 70404 (Dec. 17, 2003).

[62] Alan Reynolds, *Hold on to That Mutual Fund* WASH TIMES (Nov. 2, 2003), (avail. www.cato.org/cgi-bin/scripts/printtech.cgi/research/articles/reynolds-031102.html).

> investigation. Like static tax projections, which fail to account for behavioral responses to a proposed tax change itself, Mr. Zitzewitz's measure wrongly implies that long-term investors or fund mangers would sit passively by while returns in their funds were being deeply eroded. Not bloody likely.
>
> * * *
>
> Nevertheless, we know that market timers and late traders have made profits. And, since their activities are not on their face either wealth-producing or wealth-enhancing, we want to know where those profits came from; and, if they came from the funds, whether there were any compensating benefits. But it is certainly not acceptable to assume, as Mr. Zitzewitz did, and as Mr. Spitzer zealously approved, that timers' revenues are actually being squeezed out of long-term investors.[63]

Thus, it appears that the Commission is relying on unsupported assumptions as it makes critical regulatory decisions in an area of enormous importance. In addition, in expanding the use of fair value pricing, the Commission has failed to study or propose a concrete and effective system of conducting and controlling fair valuations and disclosing to investors the issues, methods, and risks associated with the use of fair value pricing. The Commission has made no effort in over 60 years to squeeze from the system the subjectivity, randomness, and potential abuse inherent in the use of fair valuations. This should be done through a formal study and attempt at developing best practices and binding rules governing how fair valuations are to be conducted, by whom, when, and using what methods. Division Director Paul Roye has labeled the current methods for conducting fair valuations as "guestimates."[64] Now, in the face of a massive industry scandal, and against the background of all-too-frequent abuses in the conduct of fair valuations,[65] the Commission is purporting to expand the use of fair value pricing into an

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[63] Henry G. Manne, *What Mutual Fund Scandal?*, WALL ST. J., Jan. 8, 2004, at A22.

[64] *See* transcript from Hearing Before the Subcomm. on Capital Markets, Insurance and Government-Sponsored Enterprises, *supra* note 11.

[65] *See, e.g., In the Matter of FT Interactive Data, f/k/a Interactive Data Corp.*, Investment Company Act Release No. 26291 (Dec. 11, 2003), *available at* http://www.sec.gov/litigation/admin/ia-2201.htm; *SEC v. Heartland Group, Inc.*, Litigation Release No. 16938 (Mar. 22, 2001) *available at* http://www.sec.gov/litigation/litreleases/lr16938.htm; *White v. Heartland High-Yield Municipal Bond Fund*, 237 F.Supp.2d 982 (E.D. Wis. 2002); *In the Matter of Jon D. Hammes, Albert Gary Shilling, Allan*

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area in which the statute precludes it—situations in which actual market prices are readily available. The Commission has done so not in the text of the rule—but in two of the Releases and footnotes to the Releases. These issues are far too complex and important to the investing public for the Commission to address them in the back-handed fashion set forth in the two Releases. This action violates the procedural requirements of the APA for substantive rulemaking and is arbitrary, capricious, and otherwise not in accordance with the law.

In his recent testimony before the U.S. Senate Banking Committee, Chairman Donaldson emphasized the importance of a deliberative rulemaking process to address the important issues relating to mutual fund regulation:

Footnote continued from previous page
H. Stefl, and Linda F. Stephenson, Investment Company Act Release No. 26290 (Dec. 11, 2003), *available at* http://www.sec.gov/litigation/admin/33-8346.htm; *SEC v. Edward J. Strafaci*, 03 CV 8524 (S.D.N.Y. filed Oct. 2003), SEC Litigation Release No. 18432 (Oct. 29, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18432.htm; *SEC v. Beacon Hill Asset Management LLC*, No. 02 Civ 885 (S.D.N.Y., filed Nov. 2002), SEC Litigation Release Nos. 17831, 17841 (Nov. 7, 2002) *available at* http://www.sec.gov/litigation/litreleases/lr17831.htm and http://www.sec.gov/litigation/litreleases/lr17841.htm; *In the Matter of Western Asset Management Co. and Legg Mason Fund Advisers, Inc.*, Investment Advisers Act Release No. IA-1980 (Sept. 28, 2001); *In the Matter of Ellen Griggs*, Investment Advisers Act Release No. 1836 (Sept. 27, 1999), *available at* http://www.sec.gov/litigation/admin/ia-1836.htm; 70 SEC Docket 1636 (Sept. 27, 1999); *In the Matter of Sean P. Brennan et al*, Investment Company Act Release No. 23919 (July 22, 1999), *available at* http://www.sec.gov/litigation/admin/34-41639.htm; *In the Matter of Carroll A. Wallace*, Securities Exchange Act Release No. 48372 (Aug. 20, 2003) *available at* http://www.sec.gov/litigation/opinions/34-48372.htm; 73 SEC Docket 3050 (Dec. 18, 2000); *In the Matter of Parnassus Investments et al*, Administrative Proceeding File No. 3-9317 (Sept. 3, 1998), *available at* http://www.sec.gov/litigation/aljdec/id131rgm.txt; *In the Matter of Piper Capital Management, Inc. et al*, Investment Company Act Release No. 26167 (Aug. 26, 2003), *available at* http://www.sec.gov/litigation/opinions/33-8276.htm; *In the Matter of the Rockies Fund et al*, Investment Company Act Release No. 26202 (Oct. 2, 2003), *available at* http://www.sec.gov/litigation/opinions/34-48590.htm; *In the Matter of the Bank of California, N.A.*, Investment Company Act Release No. 19545 (June 28, 1995); *In the Matter of Michael Traba*, Investment Company Act Release No. 23952 (Aug. 19, 1999), *available at* http://www.sec.gov/litigation/admin/34-41761.htm; *Van Kampen American Capital Asset Management, Inc.*, Investment Advisers Release No. 1525 (Sept. 29, 1995); *Reisman and Sems et al v. Van Wagoner et al*, (N.D. Cal. filed Jan. 4, 2002); *SEC v. National Financial Systems, Inc, et al.*, No. 03-6908 (C.D. Cal. filed Sept. 25, 2003), Litigation Release No. 18425 (Oct. 24, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18425.htm; *SEC v. Heartland Advisors et al.*, Litigation Release No. 18505 (Dec. 12, 2003), *available at* http://www.sec.gov/litigation/litreleases/lr18505.htm.

> One of the challenges in rulemaking is to anticipate the unintended consequences of some of the rules that you make. So it's a deliberate process. And if it's rushed too fast without the proper putting the rule out there for comment . . . then you make rules that have unintended consequences.[66]

We agree with the Chairman and respectfully submit this comment letter in the spirit of his comments. We believe the appropriate steps for the Commission to take are:

(1) to withdraw those portions of the two Releases that purport to modify the plain language of Section 2(a)(41) and allow or require the use of fair value pricing when actual market prices are readily available based on their being "unreliable" by virtue of being a few hours old from foreign markets;

(2) conduct a study of the effect of market timing and active trading on mutual funds and variable insurance products to determine the size and scope of the impact, and whether action is appropriate;

(3) study the various alternatives available for addressing the issue, the impact and potential benefits and adverse consequences of each alternative, and the means for appropriately conducting and controlling each alternative;

(4) consider the impact of the various alternatives on matters such as investor protection, transparency, fairness, consistency, internal control and audit, costs to investors, and other important policy objectives;

(5) study fair value pricing methodologies and methods for benchmarking, supervising, and controlling fair valuations in order to develop a more transparent, uniform, well-defined and well-controlled consensus means for conducting fair valuations in those contexts where fair valuations are necessary; and

(6) if appropriate, after sufficient study and analysis, propose a series of rules addressing the issue directly, with opportunity for public comment.

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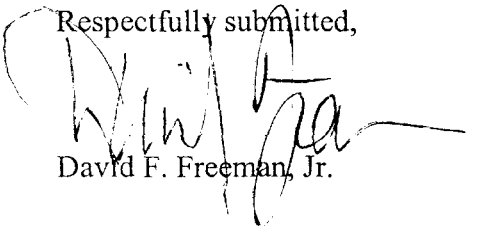
[66] *Review of Current Investigations and Regulatory Actions Regarding the Mutual Fund Industry: Hearing Before the Senate Banking, Housing and Urban Affairs Comm.*, Cong. 108, Sess. 1 (Nov. 18, 2003) (statement of SEC Chairman Donaldson). (unofficial transcript, Federal News Service).

Only ***after*** these steps have been taken and all of the comments considered and weighed and addressed, should a rule be adopted on the use of fair value pricing. To the extent legislation is required to address the issue, the Commission, after studying the issues in detail so that it is in a position to make a meaningful proposal, should refer the matter to Congress with recommendations for statutory changes.

Respectfully submitted,



David F. Freeman, Jr.