

Smith, Janet K.; Smith, Richard L.; Williams, Karyn L.

Working Paper

The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities

Claremont Colleges Working Papers in Economics, No. 2000-39

Provided in Cooperation with:

Department of Economics, Claremont McKenna College

Suggested Citation: Smith, Janet K.; Smith, Richard L.; Williams, Karyn L. (2000) : The SEC's 'Fair Value' Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities, Claremont Colleges Working Papers in Economics, No. 2000-39, Claremont McKenna College, Department of Economics, Claremont, CA

This Version is available at:

<https://hdl.handle.net/10419/94612>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

**The SEC's "Fair Value" Standard for Mutual Fund
Investment in Restricted Shares and Other Illiquid Securities***

Janet Kiholm Smith
Department of Economics
Claremont McKenna College
Claremont, CA 91711
909-607-3276
jsmith@mckenna.edu

Richard L. Smith
Drucker Graduate School of Management
Claremont Graduate University
Claremont, CA 91711
Richard.Smith@cgu.edu

Karyn Williams
Drucker Graduate School of Management
Claremont Graduate University
Claremont, CA 91711
Karyn.Williams@cgu.edu

November 1, 2000

We thank Ron Masulis and other participants of the Conference on Entrepreneurship on the Technology Frontier at the Owen School, Vanderbilt University, October 2000. We also received helpful comments from Tom Borcharding, Tom Willett, Art Denzau, and participants in the Economics Workshop of the Claremont Colleges.

The SEC’s “Fair Value” Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities

Abstract

Mutual funds generally do not invest in venture capital, private equity, or restricted shares of public companies. Consequently, individuals who desire to invest in such securities are unable to do so through diversified mutual funds. In this paper, we identify public policies and regulations that discourage mutual fund involvement in the markets for illiquid equity. We also present evidence that changes in SEC policy caused mutual funds to retreat from investing in illiquid equity. Under the Investment Company Act of 1940, the SEC requires mutual fund boards to determine and report the “fair value” of their investments in restricted shares and other illiquid equity claims. The SEC interprets fair value to mean value in current sale. Under the Investment Company Act, fair value reporting is a “certification” standard that presumes investors rely on the value representations of the fund board and its auditors. We consider whether alternatives to certification and current sale valuation could reduce barriers to mutual fund investment, without exposing individuals who invest in mutual funds to excessive risk or potential manipulation. To assess the effects of public policies, we analyze recent efforts of the SEC to apply the fair-value standard and examine court decisions arising from subsequent litigation. We also analyze the financial economics literature concerning discounts for illiquidity and the implications for valuing restricted shares. The paper concludes with a discussion of policy alternatives, including allowing funds to rely more on “transparency” in lieu of certification and allowing funds more latitude in determining and reporting the values of their illiquid securities.

The SEC’s “Fair Value” Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities

Mutual funds generally do not invest in venture capital, private equity, or restricted shares of public companies. Consequently, individuals who desire to invest in such securities are unable to do so through their investments in diversified mutual funds. While, limited partnership and other structures have certain advantages over mutual funds for investing in illiquid equity securities, the advantages are not sufficient to explain the near absence of closed-end and open-end funds from these markets. Analysis in this paper suggests that public policies and regulations preclude economically significant mutual fund involvement in the markets for illiquid equity securities. Based on our analysis, alternatives to current policies could reduce barriers to mutual fund investment without exposing mutual fund investors to excessive risk or potential manipulation.

The Investment Company Act of 1940 establishes rules and procedures for forming and operating closed-end and open-end funds. Among its provisions, the Act establishes principles for valuing fund assets, and requires each fund to regularly compute and report the net asset value (“NAV”) of its holdings. Rule 2a-4(1) of the Act provides:

Portfolio securities with respect to which quotations are readily available shall be valued at current market value, and *other securities and assets shall be valued at fair value as determined in good faith by the board of directors of the registered company...*¹

The 1940 Act charges the Securities and Exchange Commission (the “SEC” or the “Commission”) with responsibility for establishing and enforcing financial reporting policies that mutual funds must follow. Acting under this authority, in 1969 the

¹ 17 C.F.R. 270.2a4(a) (1), emphasis added.

Commission issued Accounting Series Release No. 113 (“ASR 113”).² One year later, in 1970, it issued Accounting Series Release 118 (“ASR 118”).³ These interpretive releases prescribe the SEC’s standards and policies for mutual fund valuation of privately placed and restricted shares and other assets where market quotations are not readily available.

The Act and the ASRs establish a fair value “certification standard,” where mutual fund boards are required to make good-faith fair-value determinations. The SEC requires boards to produce and maintain records of their valuation policies, deliberations, and conclusions, and to preserve the records for audit. The board “certifies” the values of the illiquid assets and the auditor “certifies” the board’s adherence to its valuation policies. The SEC constrains good faith valuation by requiring that fair value be based on “value in current sale,” fundamentally a liquidation value principle.

We present evidence that, following these changes in SEC policy, closed-end funds, in particular, retreated from investment in illiquid equity securities. Mutual fund investment in illiquid equity has remained low, despite recent rapid growth in the markets for venture capital and private equity. We attribute this to the SEC’s emphasis on fair value certification and its insistence on using the liquidation value principle.

The SEC’s guidelines for fair value reporting are now over 30 years old. This period has been pivotal in financial market thinking and research, and in legal thinking about the workings of the capital markets. Significant aspects of SEC reasoning related to the fair value certification standard, as reflected in the ASRs, are inconsistent with current

² ASR 113 is codified within Section 403 of the Codification of Financial Reporting Policies, and as Investment Company Act Release No. 5847. SEC Accounting Rules (CCH) 3758-61, at 3682-86 (October 21, 1969).

financial economic theory, capital market evidence, and legal theory applied in other settings (such as in fraud-on-the-market cases). We find that the fair-value standard biases investment company investments away from restricted shares and other fair-value assets; constrains the ability of individuals to invest in venture capital, private equity, and restricted stock; and creates incentives to devise alternative organizational forms that avoid classification as investment companies.

We compare the current certification standard to an alternative of placing greater reliance on transparency regarding a fund's holdings. We also compare the current-sale valuation principle to an alternative of allowing funds more latitude in their value determinations.⁴ Our analysis suggests that these changes would enable funds to increase investments in venture capital, private equity, and restricted shares; reduce efforts to circumvent jurisdiction of the Investment Company Act; and increase opportunities for individuals to invest in restricted shares and other illiquid equity claims.

I. Historical Perspective on Restricted-Share Regulation

A. The Securities Act of 1933 and Securities Exchange Act of 1934

The Securities Act of 1933 and the Securities Exchange Act of 1934 are the principal federal statutes that control public sale and distribution of securities.⁵ The Securities Act relates primarily to initial issuance and the Exchange Act relates primarily to subsequent trading. Under the Securities Act, issuers of registered shares sell to

³ ASR 118 is codified within Section 404 of the Codification of Financial Reporting Policies, and as Investment Company Act Release No. 6295. SEC Accounting Rules (CCH) 3750-57, at 3678-82 (December 23, 1970).

⁴ As we explain below, transparency is particularly important to closed-end fund investment, whereas relaxation of the liquidation value standard is essential to open-end fund investment.

⁵ Securities Act of 1933 (15 USCS § § 77a et seq.), referred to here as the "Securities Act," and Securities Exchange Act of 1934 (15 USCS § 78 et seq.), referred to as the "Exchange Act."

investors via a prospectus that contains SEC-prescribed information about the issuer and the offering. After the offering, investors can trade the shares in the capital markets. To encourage exchange after the initial public sale, the Exchange Act requires the issuer to report financial information on an on-going basis.

In part, these Acts were reactions to perceived abuses in the securities market before and during the Depression and to concerns that, in the absence of regulation, small investors would not have sufficient access to information. However, the Acts recognize that private transactions among sophisticated investors do not require the same level of oversight. Accordingly, they exempt from registration “transactions by an issuer not involving any public offering.”

Implementation of the private offering exemption is complex. On one hand, the SEC recognizes that an investor, at some point, is likely to want to resell shares acquired in a private transaction, and that formal registration at that point may not be practical. On the other, ability to resell without registration could enable an issuer to circumvent the intent of Securities Act registration. To balance these considerations, the acts permit secondary market sales of limited quantities of unregistered shares of public companies (“reporting companies”), that were acquired in private transactions, provided the shares were purchased originally for investment purpose and not for resale. Subsequently, Rule 144 formalized a safe harbor that could be used to meet the “investment purpose” requirement. Under Rule 144, unregistered securities could enter the public market either by registration or by gradual sale (“dribble out”) without registration, after a specified

minimum holding period.⁶ Because of these restrictions on resale, privately placed unregistered shares of public companies are referred to as “restricted shares.”⁷

B. The Investment Company Act of 1940

The Investment Company Act of 1940 is the primary legislation that governs the operation of mutual funds. The Act requires that each fund regularly compute and report the NAV of its holdings. Such a calculation is simple for publicly traded securities, where transactions prices or market value bid-ask quotations are available. Other securities, however, must be valued at fair value by the fund’s board. Beyond articulating the principle of good faith, the Act is silent as to what fair value means, how it is to be determined, or what factors a board can consider in its determination of fair value.

C. Accounting Series Releases 113 and 118

Thirty years after passage of the Investment Company Act, the SEC issued ASRs 113 and 118. It did so in response to the fact that some closed-end and open-end funds were acquiring material holdings of restricted shares. In ASR 113, the Commission states that, “For the year 1968, annual reports filed by registered investment companies indicate that open-end and closed-end companies together held in excess of \$4.2 billion of restricted equity securities. Open-end companies accounted for about \$3.2 billion of these restricted securities which represented 4.4 percent of their total net assets.”⁸

⁶ Rule 144 was enacted in 1972 and was anticipated in the drafting of the ASRs. The holding period requirements of the Rule have changed over time and are somewhat different if the holder is deemed to be a “control person” or “affiliated investor” of the issuing firm.

⁷ Restricted securities also are known as “letter stock” because of the practice of requiring the buyer to furnish an “investment letter” representing that the purchase is for investment and not for resale. This serves to substantiate that the transaction is within the “private offering exemption” from registration under 4(2) of the Securities Act. The term “restricted shares” sometimes is used more broadly to include shares of non-public companies. We refer to shares of non-reporting companies as private equity.

⁸ ASR 113. See also, Federal Register, vol. 35, no. 253, Part 211, Thurs, December 31, 1970, p. 19989.

The SEC's concern with investment in restricted shares is apparent in an SEC study published in 1971, but with much of the analysis completed during 1969.⁹ In it, the Commission points to "competitive pressures on portfolio managers to improve investment performance," and states, "One disquieting result of these pressures has been to provide an incentive for investment managers to assume higher and higher levels of investment risk.... a result that often is not apparent to the portfolio's sponsors or beneficial owners" (p. xiii). Based on survey data, the SEC reports a rapid increase in mutual fund investments in illiquid equity (including restricted shares, venture capital, and private equity investments). Investments by survey respondents in such securities increased by 91 percent from 1966 to 1967, and by 315 percent from 1967 to 1968, an overall increase of 694 percent from the 1966 base. In 1968 mutual funds accounted for 29 percent of institutional investment in illiquid equities, compared to 13 percent in 1966 (p. 2420).¹⁰ The study expresses concern that the mutual fund investments were concentrated among a few funds. In the SEC's sample, five open-end funds that were early movers into the market accounted for 83.7 percent of surveyed holdings (p. 2494). The study also notes that institutions were following divergent valuation practices, and identified this as a basis for concern (e.g., p. 2473).¹¹

ASR 113 provides the SEC's rationale for its oversight of investment company practices for valuing illiquid equity. The release states, "proper valuation of portfolio

⁹ *Institutional Investor Study Report of the Securities and Exchange Commission*, Securities and Exchange Commission, (U.S. Government Printing Office Washington, 1971).

¹⁰ Absolute dollar investment declines in 1969, possibly an effect of SEC valuation policies under ASR 113.

¹¹ See the *Institutional Investor Study Report of the Securities and Exchange Commission*, vol. 5, Securities and Exchange Commission, (U.S. Government Printing Office Washington, 1971). In the study, 33 percent of dollar-valued holdings were carried at the current market price of freely traded shares

securities” is “critically important,” because “distortions in the valuation of a restricted security [including private equity]...will distort the price at which the shares of the investment company are sold or redeemed.”¹² The SEC notes that fund managers who are compensated on the basis of NAV or performance can succumb to incentives to overvalue their holdings. Further, the SEC expresses its concern that overvaluing illiquid equity holdings can mislead investors.

In ASR 113, the SEC takes a strong position against using the market values of public shares to value otherwise-identical restricted shares. The Commission’s view is that market quotations only are appropriate for valuing securities that are similar *in all respects* to the securities for which market transaction prices are observed. “For valuation purposes, therefore, restricted securities constitute securities for which market quotations are not readily available.”

Noting that restricted securities often are purchased at discounts relative to the market price of unrestricted securities, the SEC asserts the following rationales for the discounts:

This [discount] reflects the fact that securities which cannot be readily sold in the public market place are less valuable than securities which can be sold, and also the fact that, by the direct sale of restricted securities, sellers avoid the expense, time and public disclosure which registration entails.

To properly value restricted securities, the SEC advocates, for the first time, value in “current sale” as the valuation principle against which fund decisions are judged.

less a discount, 41 percent were carried at the current market price of unrestricted shares, 5 percent were carried at acquisition cost, and 21 percent were carried at other values. See p. 2473.

¹² ASR 113 states, “The offering price of securities issued by a management investment company is premised upon the net asset value.... The improper valuation of restricted securities... would distort the net asset value of the shares being offered or, in the case of an open-end company, redeemed, and would therefore constitute a fraud and deceit within the meaning of Section 10(b) and Rule 10b-5.”

Current-sale is a liquidation value measure. It precludes valuing restricted shares either at the market value of freely traded shares or at the fund's cost of acquiring the shares.¹³

At the same time that it precludes valuation at cost or at the market value of identical registered shares, ASR 113 precludes reliance on mechanical or formulaic relations between restricted share value and registered share market value. A fund may not, for example, value restricted shares by applying "a constant percentage or an absolute dollar discount to the market quotation for unrestricted securities of the same class." In the view of the SEC, such approaches are inconsistent with "good faith". Nor may a fund rely on mechanical or formulaic amortization of the restricted share discount at the time of the fund's investment in the shares.¹⁴ In taking this position, the SEC precluded reliance on any of the valuation approaches that were in common use by funds.

More fundamentally, the SEC suggests that any approach that relates restricted-share value to the market value of unrestricted shares can be problematic.¹⁵ ASR 113

¹³ "As a general principle, the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. This depends upon their inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature. *Consequently, the valuation of restricted securities at the market quotations for unrestricted securities of the same class would, except for most unusual situations, be improper. Further, the continued valuation of such securities at cost would be improper if, as a result of the operations of the issuer, change in general market conditions or otherwise, cost has ceased to represent fair value.* In such circumstances, maintaining the value of the restricted securities at cost would mislead investors as to the value of the portfolio of the investment company which holds restricted securities." [Emphasis added].

¹⁴ "[T]he practice of automatically amortizing the discount over an arbitrarily chosen period creates the appearance of an appreciation in the value of the securities which has not, in fact, occurred, and accordingly, is improper.... An undertaking by the issuer to register the securities within a specified time would not dictate a different result. In view of the many factors that may alter the date of the proposed public offering, it is at best speculative to use such an undertaking alone as the basis for amortizing the discount....[T]he ...adoption by the Commission of the more definite holding periods contained in proposed Rules [i.e., Rule 144, as discussed above and enacted in 1972]...would also not alter the conclusion that amortization of the discount may be improper. [T]he more definite holding periods...are available only if certain specified conditions are met." [Emphasis added].

¹⁵ "[T]he valuation of restricted securities by reference to the market price of unrestricted securities of the same class assumes that the market price for unrestricted securities of the same class is representative of

explicitly states a concern with the potential for stock price manipulation by investment companies when purchasing restricted shares:

With a thin market, the news of the investment company's purchase of the restricted securities may, by itself, have the effect of stimulating a public demand for the unrestricted securities, the supply of which has not been increased, and thus lead to a spiraling increase in the valuation of both the restricted and unrestricted securities.¹⁶

In summary, the SEC concludes,

[T]here can be no automatic formula by which an investment company can value restricted securities in its portfolio.... It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith; and the data and information considered and the analysis thereof should be retained for inspection by the company's independent auditors. While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined. [Emphasis added]

ASR 118 reiterates discussion from the earlier release. It clarifies that, for each asset in its portfolio, an investment company is required to report both acquisition cost and (current sale) value, and to disclose its valuation policy and methodology.^{17,18}

the fair value of the securities. This may not be the case when the market for the unrestricted securities is very thin, i.e., only a limited volume of shares are available for trading.”

¹⁶ This concern may reflect the now documented finding that, on average, share prices of public companies increase when companies place equity privately. See studies by Wruck (1989), Hertz and Smith (1993) and Krishnamurthy, et al. (1999). The SEC statement suggests that the run-up may reflect manipulation and that a company may place equity privately to induce an increase in its unrestricted share price. In contrast, the financial economics literature suggests the unrestricted share price increase can be a rational market response to news of private investment. That is, the willingness of a well-informed investor to commit new funds, even at a discount, can be a positive signal about the value of the company.

¹⁷ ASR 118 states: “In some circumstances value can be determined fairly in more than one way. Hence [the SEC's] standards...should be considered as guidelines. These standards should be followed, and a company's stated valuation policies should be consistent with them. Any variation from the standards should be disclosedIn addition, any deviation from a stated valuation policy...should be disclosed.”

¹⁸ “As a general principle, the current “fair value” of an issue of securities...would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. Methods which are in accord with this principle may, for example, be based on a multiple of earnings, or a discount from market of a similar freely traded security, or a yield to maturity with respect to debt issues, or a combination of these and other methods. Some of the general factors which the directors should consider in determining a valuation method...include: 1) the fundamental analytical data relating to the

The orientation of the 1940 Act and the ASRs is that investors should be able to rely on the NAVs reported by fund managers. To achieve this, the regulations formalize a certification structure and require that fair-value assets be valued based on the current-sale principle. The implicit regulatory theory of certification is that litigation risk creates incentives for the board and auditor to provide reliable evaluations. Both the current-sale (or liquidation value) principle and the certification approach are problematic from an economics perspective. We consider these issues in the next two sections.

II. The Economics of Liquidity and the Current-sale Principle

A. The Role of NAV for Open-end Versus Closed-end Funds

In ASR 113, the SEC states, “It is critically important [to investors] that an investment company properly value its portfolio securities,” but the Commission does not distinguish between the differing roles of NAV to closed-end and open-end funds. In fact, the SEC’s premise, that a distortion in restricted share valuation will distort the price at which fund shares are sold or redeemed, only applies directly to open-end funds. Investors in open-end funds always transact directly with the fund at NAV per share. New investments create new fund shares and increase the fund’s capital under management. Sales of shares are redemptions and reduce capital under management. Thus, management of an open-end fund cannot avoid determining the NAV of its holdings on a continuing basis. If management overstates the values of restricted shares, fund NAV

investment, 2) the nature and duration of restrictions on disposition..., and 3) an evaluation of the forces which influence the market in which these securities are purchased and sold. Among the more specific factors which are to be considered are: type of security, financial statements, cost at date of purchase, size of holding, discount from market value of unrestricted securities of the same class at time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting the securities, price and extent of public

will be overstated and fund investors will pay too much. The SEC's apparent concern is primarily with positive distortions of NAV.

In a closed-end fund, the manager raises capital by selling publicly tradable shares. This is a primary market transaction. Anyone who wishes to invest in the fund after the offering can do so only by exchanging already outstanding shares with another investor. This secondary market transaction generates no new capital for the fund.

Because closed-end fund shares trade in the secondary market, their market values can differ materially from reported NAV.^{19,20} Such differences arise for a variety of reasons: embedded tax liabilities might lead investors to value shares at a discount; fund managers may be perceived to be particularly capable of adding value or not; and NAV may be perceived to be an inaccurate estimate of true value.²¹ Differences between NAV and market values may be of little relevance to investors in closed-end funds that invest in restricted shares of reporting companies. The fund's valuation methodology is likely to involve benchmarking against the market values of freely tradable shares and is subject to the SEC's constraints. As long as investors have access to specific information about the fund's holdings, the board's valuation is unlikely to contribute to market valuation.

trading in similar securities of the issuer or comparable companies, and other relevant matters.” [Emphasis added].

¹⁹ Of the 500 closed-end funds in existence at the end of 1999, 14% were equity funds. On average, approximately 75 percent of the closed-end funds traded at a discount in 1999, with an average discount of 5.73%. See Wiesenberger Investment Co. Services, *Investment Companies Yearbook 2000* (Wiesenberger, Thompson Financial Services, 2000), at pg. 30. Based on this evidence of divergence in NAV and market value, one cannot presume that reporting errors in NAV will necessarily affect the market value of the fund.

²⁰ SEC rules permit closed-end funds periodically to repurchase shares at NAV, but do not require them to do so. Generally the funds do not repurchase shares.

²¹ For discussion of the reasons for closed-end fund discounts, see, e.g., Brickley, Manaster, and Schallheim (1991), Lee, Schleifer, and Thaler (1991), Pontiff (1995), Thompson (1978), Weiss (1989).

B. How Illiquidity Affects Value

Other things the same, an asset is more valuable if it is liquid. However, the meaning of “illiquidity” is ambiguous, and empirical evidence that can be used to assess the value of liquidity often is misunderstood. In this section, we address three issues. First, on fundamental grounds, how important is liquidity as a determinant of the value of a fund’s investment? Our reasoning suggests that illiquidity of fund investments is unlikely to be a very important determinant of value. Second, how does the empirical evidence on transactions of illiquid assets relate to determination of the value of liquidity? Large discounts in private transactions are associated with information problems that make trading uneconomical and are not necessarily due to legal or contractual restrictions on liquidity.²² Third, in light of the first two issues, is current sale value the economically correct standard to use for fund NAV determination?

A useful distinction exists between illiquidity due to a legal or contractual impediment to sale, and illiquidity due to information asymmetry or other problems that contribute to high costs of transacting. While a holder of restricted shares has fewer options than does a holder of registered shares, that difference need not result in a material difference in value. Restricting resale is costly only if the resulting illiquidity limits investor choice. If resale restrictions relate to a small fraction of an investor’s portfolio and the investor relies only on public information, then the illiquidity does not materially

²² Legally or contractually imposed resale restrictions can significantly reduce value for an underdiversified investor because it constrains the investor to remain underdiversified. However, in the context of mutual fund valuation, the effect of underdiversification on the value of illiquid assets is not relevant.

disadvantage the investor.²³ This principle is implicit in the portfolio investment decisions of institutional investors. Open-end funds often formally limit their maximum investments in illiquid and restricted share to levels where fund redemptions would not require liquidating such shares.²⁴ Closed-end funds can, in principle, invest more aggressively in illiquid and restricted securities, as they do not face the same liquidity concerns. Other significant investors in illiquid securities (insurance companies, pension funds, and endowments) either limit the investments to levels where liquidity is not a concern, or (as in the cases of venture capital funds and closed-end funds) adopt structures that do not require them to provide direct liquidity for investors.

Investors in restricted shares seek to earn return premiums by investing in illiquid assets. Two factors contribute to the potential premium. The first is the supply of and demand for funds available for investing in illiquid assets. If the pool of funds is small relative to investment opportunities, then investors willing to bear illiquidity risk can earn superior returns. Second, an investor in the restricted shares of a particular company may be able to earn a superior return by having an information advantage over other investors. Normally, the investor realizes the return by purchasing at a discount that reflects the return other investors would require to compensate for their concerns about information asymmetry, and for their due diligence cost of investing. The return premium is a gain the investor may capture by virtue of its prior (sunk) investment in information about the

²³ While a party with private information would be disadvantaged by a trading restriction, the restriction puts the investor on equal footing with others who do not have the information. Removing the restriction would increase the private value of the shares, potentially to a value higher than the prevailing market value.

²⁴ Actual holdings of illiquid equity securities are substantially below the formal limits.

issuer. This return is actually a quasi-rent associated with the pre-existing informational advantage of the investor. It is not a market return for bearing illiquidity risk.²⁵

Presumably, issuers and secondary market sellers of restricted shares also are seeking to maximize value. Their decisions to issue or sell reflect their determinations that selling in a private transaction is economically preferred to alternatives such as selling in a public offering or foregoing a sale. It follows that observed discounts on private sales must either be small compared to alternative ways of raising capital, or sellers must be under pressure to generate funds, and have no less costly alternatives.

Because restricted-share transactions often occur when an issuer is under liquidity pressure, interpreting the evidence on discounts and applying the current-sale principle are problematic.²⁶ Economic theory provides no basis to expect a large return premium for bearing illiquidity risk. A variety of institutional investors can make restricted share investment without materially affecting their liquidity. Such investors would benefit even from very small returns for bearing illiquidity risk. Currently, and in past decades, institutional holdings of illiquid assets have been small in comparison to any foreseeable need for liquidity. Thus, low transactions prices of restricted shares and other illiquid asset cannot be driven by institutional investors' liquidity needs.²⁷ Nor can large discounts be driven by the value of foregone put options that marketable shares provide. Without

²⁵ An investor in registered shares might also invest, hoping to gain by selling on inside information later. Restrictions on resale limit this opportunity. However, the lost opportunity should not affect the expected return on investment unless insider trading significantly affects market returns on unrestricted shares.

²⁶ The SEC indicates that the current-sale principle does not mean value in a "fire sale." However, even allowing more time to locate buyers, the current-sale principle does not recognize that informational asymmetry and costs of discovering information are primary determinants of transaction value.

²⁷ While individual investors may have liquidity needs that would cause them to discount the values of illiquid assets, such discounts reflect private valuations, not market valuations. Market valuations are determined by the liquidity needs of the marginal investors in illiquid assets (i.e., the institutional investors).

private information, the put option is of negligible value, as the option exercise price is always equal to the contemporaneous market price of the underlying security.²⁸

C. Empirical Evidence on Liquidity Discounts

Observed returns for investing in restricted shares include the premium for bearing illiquidity risk, and the premium associated with information asymmetry and due diligence costs. Economic reasoning suggests that the observed returns are predominantly associated with information asymmetry and due diligence, and not with illiquidity risk. If so, returns should only be realized where informational asymmetries are economically significant, and the issuer is unable to overcome the information problems at low cost. Thus, empirically, investors would earn superior returns when an issuer faces an immediate need for cash and where an investor is uniquely positioned to exploit important private information it has about the value of the securities being sold.

One way to distinguish between returns for bearing illiquidity risk and returns due to information problems is to examine variation in discounts associated with placements of restricted securities with different potential for information problems. A useful place to

²⁸ An investor with access to private information would value freely tradable shares more highly than restricted shares. However, as long as market values reflect value to investors who do not have private information, reduced ability to trade on private information would not result in a discount for restricted shares. Longstaff (1995) derives upper bound estimates on the value of value of liquidity to an investor who has perfect market timing ability. He concludes that the value of liquidity to such an investor can be substantial. He also compares his upper-bound estimates to empirical estimates of actual discounts on restricted-share investments and finds that the discounts are similar in magnitude to his upper-bound estimates. In an environment where it is not possible to forecast overall market performance, perfect market timing is the analytical equivalent of perfect inside information about firm value. The association between the theoretical upper-bound and empirical estimates of restricted share discounts can be justified if it is assumed that the market values of unrestricted shares are determined by perfect market timers and that the investor in restricted shares would otherwise have had the same ability to exploit investors who could not market-time. Our discussion of the value of the foregone option reflects the opposite assumption, that market values are driven by investors who lack inside information and that the value of an unrestricted security to a market timer is not verifiable. Our reasoning implies that value to a perfect market timer would be found by adding the value of the timing option to the market value of freely-tradable shares.

begin is with the 1988 Blackwell and Kidwell study of relative costs of publicly-issued and privately-placed debt. They examine expected yields on net proceeds for firms that switched between public issues and private placements.²⁹ Despite legal restrictions on resale of unregistered debt, they find no significant difference in yield on net proceeds between private and public issues. Their analysis suggests that issuers rationally switch between public issue and private placement, thereby driving the returns for investing in liquid and illiquid debt to similar levels. For the issuers in the Blackwell and Kidwell study, informational concerns, as the firms were all issuers of investment grade debt. Correspondingly, the private placement discounts were negligible.

There have been many studies of equity private placements. All find that, on average, the discounts relative to registered shares, are substantial.^{30,31} More detailed examination demonstrates that most of the discount is related to informational concerns, and not directly to illiquidity. In their study of equity private placements, Hertz and Smith (1993) find that the size of the discount is related to the cost of becoming informed about the value of the securities. Discounts are larger for firms that are difficult to value, such as firms involved in new product development and firms with high risk of financial

²⁹ Blackwell and Kidwell (1988) base their study on data from before enactment of Rule 144A. Rule 144A helped to establish a secondary market for privately-placed debt among Qualified Institutional Buyers, who are deemed not to require the protection of the 1933 and 1934 Acts.

³⁰ The SEC (1971) estimates that the average restricted share discount in its sample from the late 1960s was 23.1 percent, measured against the ask price for unrestricted shares. For a sample of small private placements from the 1980s, Silber (1991) reports an average discount of 33.75%, measured against closing price on the placement date. For a sample of large private placements of unregistered shares by exchange-listed firms, from 1979 through the mid-1980s, Wruck (1989) finds an average discount of 13.5%. Using a sample of private placements from the 1980s, Hertz and Smith (1993) find that the average discount on placements of restricted shares was 42 percent, measured against the market closing price 10 days after the placement, which corresponds to a discount of 33 measured against the market closing price three days before the placement. For a sample of restricted shares from the 1980s and early 1990s, Krishnamirty, et al. find a discount of 34.02%, measured against market closing price 10 days after the placement.

distress. They estimate that the effect of restricted trading on the discount is 13.5 percent of the value of unrestricted shares. Even for shares that are not restricted, discounts range from very large to zero or slight premiums. Based on their evidence, Hertz and Smith ascribe most of the private placement discount to the due diligence costs an arms-length investor would have to incur, quasi-rents derived from an investor's ongoing involvement with the issuer, and urgency of the issuer's need for liquidity.

Silber (1991) finds that restricted share discounts are inversely related to the issuer's credit worthiness and finds some cases of restricted shares being sold at premiums.³² He ascribes premiums to considerations such as board representation, factors that receive little attention in the ASRs. Krishnamurthy, et al. (1999) find a similar overall result. In their sample, the average discount is 10.7 percent greater than for placements of shares with registration pending. They also find evidence that issuers choose rationally between private placement and public offering, and that firms with higher levels of informational asymmetry are more likely to select private placement.³³

D. Current Sale and Alternative Measures of Fair Value

The current-sale principle is at the core of potential value distortions resulting from adherence to the ASRs. Fund boards and managers must apply the principle to assets that they have no current intention or expectation of liquidating. Reliance on market prices in

³¹ Some argue that the private placement evidence supports discounts in excess of 50 percent. See, for example, Arneson (1981).

³² Several studies of the discount find that some restricted and unrestricted shares are placed privately at premiums. See, e.g., SEC (1971) and Hertz and Smith (1993).

³³ If illiquidity caused by resale restrictions contributes to returns, then opportunities to benefit significantly by investing in restricted securities may not persist. The Rule 144 restriction period recently was reduced from two years to one. With the supply of restricted-securities constant, this change effectively doubles the flow of funds available for restricted-security investment. 17 CFR Part 20 [Release No. 33-7390; File No. S7-17-95] Revision of Holding Period Requirements in Rules 144 and 145 (February 2, 1997).

actual transactions of restricted shares to establish current sale value causes the shares to be valued as if they were to be sold to an investor who would have to incur due diligence costs similar to the costs investors would incur in dealings with ventures under pressure to add liquidity. Yet, it is unlikely that a mutual fund would purchase restricted shares hoping to realize an immediate gain in a private sale.

Current sale is only one of several valuation principles that have been applied to the term “fair value.”³⁴ Depending on how the valuation is to be used, alternatives such as acquisition cost, present value of future cash flows, or other measures could be more relevant to investors. The Financial Accounting Standards Board (FASB), in SFAS 107, articulates an exit value notion of fair value that is consistent with the SEC’s current-sale principle. In SFAS 107, fair value is the exchange value of an asset in a current transaction between willing parties, other than in forced liquidation. As Barth and Landsman (1995) note, depending on how investors use the information, entry value, exit value, and value-in-use all are reasonable constructs of fair value. Entry value may be measured as acquisition price or replacement cost; exit value is sale or liquidation price; and value in use is going-concern value, or present value of future cash flows.³⁵

The fair-value definition most relevant to restricted and illiquid shares is a going-concern measure. Such a measure is an estimate of the amount an owner would demand for giving up the rights to the future benefit stream, such as in a condemnation. This definition properly focuses the valuation of restricted shares on present value of expected future cash flows, and not on a transaction value in a sale motivated by the asset owner.

³⁴ Fair value as applied in the ASRs is part of a broader dialogue related to fair value accounting. The FASB, for example, has issued standards requiring disclosure of fair value for assets, liabilities, and financial instruments (Statement of Financial Accounting Standards 87, 105, 107, 115, 119, 121).

Customary accounting definitions, like the SEC definition, make no mention of a value-in-use concept for assets without active exchange markets, and say nothing about the value of private information the buyer and seller may possess.

For financial assets held by passive investors such as mutual funds, going-concern value (or present value of future cash flows) and the value in a buyer-motivated transaction should be equivalent, but for the buyer's transactions costs. The difficulty is that, without active trading of the claims in a capital market, there is no objective and verifiable measure of value. Private sales of restricted shares, which are observable, often are seller-motivated, and the sellers often face financial distress or engage in high-risk business activities. Thus, transaction prices in seller-motivated exchanges are negatively biased measures of the values of assets that investors choose not to sell.

The current-sale principle makes economic sense when valuing assets that an owner intends to sell in the near future, perhaps to meet liquidity needs. Present value of future cash flows, a value-in-use measure, makes more sense if the asset is a long-term investment, such as a venture capital investment in a non-public company or an investment in restricted shares. Market value of otherwise identical, freely tradable shares is a measure of present value. This measure has merit when the value of liquidity is small, and when investors purchase restricted shares with the expectation that the shares will be held until after trading restrictions no longer apply.

E. Implications for Restricted Share Valuation by Investment Companies

The SEC is critical of other measures of fair value, as they generally would result in recording immediate gains in value after an investment. However, from a financial

³⁵ See also, Beaver (1987).

economics perspective, the current-sale principle fails to recognize that much of the value in a restricted-share purchase is created at the time of the purchase. Furthermore, at the time of purchase, the fund is likely to incur due diligence and other costs associated with valuing and acquiring the securities. These costs can affect the purchase price of the shares. The fund normally reports the costs as operating expenses. Hence, adherence to the current-sale principle effectively double-counts the fund's cost of making the investment and builds an unrecognized gain into the fund's NAV calculation.

III. The Certification Standard

Certification is relied on extensively as a device to enhance capital market efficiency and to promote liquidity. Corporate boards of directors effectively certify the reports they file with the SEC and distribute to investors, and auditors certify that financial statements are consistent with generally accepted accounting principles. Underwriters, board members, and others effectively certify the representations contained in offering prospectuses and the absence of material omissions. In contexts such as these, investors rely on certification because direct observation is not as economical.

However, certification is not a perfect substitute for direct observation. Fair-value certification is a case in point. Fair-value determination by a mutual fund board is only important to investors if they do not have other reliable means of determining value. If a fund owns restricted shares of reporting companies and the information on its holdings is public, the board's value determinations can be redundant to information already available in the market.³⁶ Given that ability to transmit detailed information to investors about fund

³⁶ Court rulings in "fraud-on-the-market" cases recognize that a firm may not be able to conceal information from investors if the same or similar information is available to the market by other means. A corollary, the "truth-on-the-market" defense states that a plaintiff cannot rely on the fraud on the

holdings has improved since the ASRs were introduced, the importance of reported NAV to fund investors has diminished. On the other hand, if certification of fair value is substituted for more direct and specific information about a fund's holdings, investors can be worse off than with a transparent description of the fund's holdings.³⁷

One problem with certification is that well-intentioned boards can fail to estimate accurately the values investors would ascribe to the fund's holdings of illiquid assets. Expert opinions about value can differ dramatically, even for restricted shares of reporting companies. The ASRs, despite the limitations they place on *approaches* to fair-value determination, still give broad latitude with respect to the *values* boards assign.

A second problem is that a board might conclude that adherence to the ASR guidelines would not result in a valuation that is fair to current and new investors in the fund. In particular, the board may reject the SEC's position that current sale is the proper measure of the value, or it may disagree with the SEC's position about the importance of liquidity as a determinant of value. In such cases, board members can abandon their beliefs, or depart from the guidelines and face increased litigation risk.

A third problem with certification is that the ASRs provide a roadmap to boards that wish to distort their reported NAVs. As the cases below illustrate, the focus of SEC litigation over restricted share valuation is more on valuation *process* than on correct *valuation*. As long as a board maintains records of its deliberations and does not value its restricted share holdings too highly, its conclusions about value are difficult for the SEC to

market theory to establish reliance when information correcting the fraudulent disclosure was readily available in the marketplace at the time of the fraudulent disclosure. See *Associated Randall Bank v. Griffin, Kubik, Stephens and Thompson, Inc.* 3 F3d 208, 214 (7th Cir 1993) and *Wallace v. Systems & Computer Technology Corp.* Fed Sec. L. Rep (CCH 99, 578 at 97, 868 (E D Pa 1997).

challenge.³⁸ Furthermore, the ASRs provide no guidance for valuation of investments in private companies. Thus, within a broad range, the ASRs do not prevent a board from manipulating its valuations of fair-value assets.

In the context of the certification standard, these problems create incentives for investment companies subject to the 1940 Act to avoid fair-value assets. As described below, entities that wish to invest in non-market assets, now devise organizational forms that enable them to avoid classification as investment companies. This allows them to avoid the SEC's version of fair-value, as well as other provisions of the Investment Company Act. The result is that current regulations reduce the abilities of individuals to invest in venture capital, private equity, and restricted shares, compared to a regulatory regime where a fund's costs of holding such assets are less onerous and less constraining.

IV. The Impact of the Fair Value Certification Standard

Despite tremendous changes in financial markets over the last thirty years, the SEC still applies ASRs 113 and 118 in its reviews of mutual fund reporting practices. In addition, though fund investments in fair-value assets are now extremely limited, the SEC occasionally initiates litigation based on its perception that a fund has deviated from the ASR principles. Under the certification structure, investors can initiate legal action if they believe a fund has incorrectly valued its investments in fair-value assets.

To assess the economic significance of fair value certification, we examine the current investment practices of investment companies regarding restricted or illiquid securities. To provide a micro-perspective, we analyze two recent SEC actions, one

³⁷ Some funds may prefer to limit transparency for strategic reasons. To the extent that they do, accurate valuations by the board are more important to investors.

³⁸ See discussion of *Parnassus*, *infra* at p. 25 and *Mears* at p. 32

involving an open-end fund, the Parnassus Fund, and the other involving a closed-end fund organized as a Business Development Company, Corporate Capital Resources, Inc.³⁹

A. Impact on Investment Practices of Open-end Funds

The open-end structure is appropriate primarily as a vehicle for investing in assets that are freely tradable and liquid. Liquidity enables the fund manager to respond to changes in demand for fund shares. Nonetheless, within the bounds of providing for liquidity needs, open-end funds can devote a fraction of their resources to investments in illiquid assets. Doing so would enable open-end funds to enhance portfolio returns by accepting illiquidity risk and by capitalizing on informational advantages that they may have about specific companies.⁴⁰ This was the direction in which some mutual funds were headed in the late 1960s, before the ASRs were introduced.

A1. Evidence on Restricted Share Holdings of Open-end Funds

Based on concerns that open-end funds maintain adequate liquidity, the SEC recommends that they limit investments in illiquid assets to a maximum of 10 to 15 percent of fund value.⁴¹ Even open-end funds that specifically target investments in small and

³⁹ A Business Development Company (BDC) is a type of closed-end fund; BDCs can own larger fractions of the equity of their portfolio companies and be more involved in managerial aspects of the companies than can other closed-end funds. BDCs still are subject to “fair value” certification of holdings.

⁴⁰ Nanda, Narayanan, and Warther (2000) develop a model of open-end funds where those with investments in illiquid assets use exit fees to limit withdrawals, and where investors with low liquidity needs earn higher returns by foregoing liquidity withdrawals. They argue that open-end funds offer advantages over closed-end funds when investors are uncertain about manager quality. They do not address bias in NAV measurement. However front-end loads and exit fees also limit investors’ ability to arbitrage pricing biases.

⁴¹ The SEC takes the position that open-end funds should maintain at least 85 percent of NAV in assets that can be sold within seven days at approximately the price used in determining NAV and that 10 percent is a prudent limit on investment in fair-value assets. See 17 CFR Part 271, “Interpretive Release Relating to the Investment Company Act of 1940 and Rules and Regulations Thereunder: Restricted Securities,” December 31, 1970, and 17 CFR Parts 239, 240, 270, and 274, “Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or With Extended Payment,” August 6, 1992, at Section II.D.

early-stage companies have adopted the SEC's guideline. The policy of Pioneer Micro-Cap Fund, for example, limits investments in illiquid assets to not more than 15 percent of net assets.⁴² Similarly, Invesco Emerging Growth Fund I limits investment in restricted and illiquid securities to 10 percent or less of total assets.⁴³ In a prospectus of its Emerging Growth Fund, Small Company Value Fund, Small Company Growth Fund, and Post-Venture Capital Fund, Warburg Pinchus states, "Each of the Post-Venture Capital and Small Company Growth Funds may invest up to 15% of its net assets (10% of total assets in the case of the Emerging Growth and Small Company Value Funds) in non-publicly traded and illiquid securities...."⁴⁴ The prospectus notes, "Mutual funds do not typically hold a significant amount of these restricted or other illiquid securities because of the potential for delays on resale and uncertainty of valuation."⁴⁵

Although SEC requirements and the stated investment policies of open-end funds are sufficient to preserve liquidity, actual holdings of fair-value equities are much more limited than suggested by the policies. The *Morningstar Mutual Fund 500* conducts surveys open-end funds annually and reports the percentage held of "restricted/illiquid securities." In the most recent survey (2000), we selected those funds that specialize in equities and collected information on the reported share of assets that are restricted or illiquid. With minor exceptions involving small funds, the share of securities that are restricted or illiquid was reported as "trace" or 0-1%.⁴⁶ Thus, open-end funds, even those specializing in small-cap equities, now generally avoid restricted securities.

⁴² Pioneer Micro-Cap Fund, Form 497, March 30, 1999.

⁴³ Invesco Emerging Growth Fund I, Form 497, September 11, 1995

⁴⁴ Warburg Pinchus, Form 497, January 3, 2000, p. 29.

⁴⁵ Warburg Pinchus, Form 497, January 3, 2000, p. 29.

⁴⁶ *Morningstar Mutual Fund 500* (2000).

Virtual abandonment of restricted-share investment by open-end funds suggests that the fair-value standard has reduced such holdings below the level one could expect based solely on liquidity considerations. The decline appears to be a direct response to the SEC's fair value policies, including the current-sale principle. Additional support for this conclusion is that open-end fund holdings of privately-placed debt (by debt-oriented funds) are much higher and in line with SEC policy limits. Debt investments are not subject to the same valuation difficulties as equity, are not required to be valued based on current-sale, and are more easily tradable with other institutions under Rule 144A.

A2. Case Study: *In Matter of Parnassus the Investments (1998)*⁴⁷

Because open-end funds have withdrawn from ownership of fair-value assets, litigation is rare. One exception is the Parnassus Fund. The Fund invested in restricted shares when one of its portfolio companies, Margaux, Inc., faced a liquidity crisis and came to Parnassus seeking capital on terms advantageous to Parnassus. The Fund's response exemplifies the pitfalls of open-end fund investment in restricted shares.

During the late 1980s, Parnassus accumulated 640,000 registered shares of Margaux at an average cost of \$1.26 per share.⁴⁸ In March 1989, Margaux filed for bankruptcy under Chapter 11. After the announcement, Margaux shares declined in value to \$.28, at which price Parnassus purchased 250,000 more registered shares. In April 1989, Margaux, faced with a liquidity crisis, approached Parnassus for an investment. Parnassus loaned Margaux \$100,000 to help it remain a going concern. The loan was convertible to 1.5 million shares of restricted Margaux stock. At the time, year-end 1989, the Fund's total NAV was \$23.0 million, and the loan represented 0.4 percent of NAV.

Initially, Parnassus valued the investment at the note's face value of \$100,000. In October 1989, when the conversion rights were approved by the bankruptcy court, Margaux's registered stock was trading for \$.44. In January 1990, the Parnassus board decided to value the note at its conversion value, based on the market value of freely tradable Margaux shares (i.e., \$660,000, or 2.9 percent of the Fund's year-end 1989 NAV). In making the determination, the board gave no consideration to the fact that the shares to which the loan was convertible would be restricted. The Fund carried the note at its conversion value until August. At that point, it added a 10 percent premium to the note's value to reflect the convertibility feature.

In December 1990, the Fund's board decided to shift from market value to fair value for holdings of Margaux. At that time, Margaux shares were quoted in the "pink sheets" at a spread of \$.05 (bid) to \$.10 (ask).⁴⁹ The Fund's manager indicated that he did not believe the pink sheet price was a reliable measure of fair value. The board elected to maintain the value at \$.344 based on its view of Margaux's future prospects.

In February 1990, Margaux informed Parnassus that it was performing below expectations. In March 1991, the board reviewed its valuation and determined not to adjust the value. It continued to carry the loan at a conversion value of \$516,000 or 2.5 percent of Fund NAV. The Fund's auditor, Deloitte & Touche, reviewed the valuation and methodologies used by the board and found them in accordance with generally accepted accounting principles. In December 1991, after further under-performance by Margaux, but positive cash flows, the board retained its valuation. By then, the Fund had

⁴⁷ Initial Decision Release No. 131, Administrative Proceeding, File no. 3-9317, September 3, 1998.

⁴⁸ The position represented 7.4 percent of the fund's 1988 year-end NAV.

grown significantly and its convertible debt position accounted for 1.6 percent of Fund NAV. In July 1992, Margaux showed improving performance, but the Fund's board retained its prior valuation. The board retained the same valuation in December 1992 and continued to grow, so the convertible debt position accounted for 0.9 percent of NAV.

In January 1994, the Fund became aware that Margaux's key customer was having problems. Based on that information, the board reduced its valuation of Margaux to \$.20 and eliminated the 10 percent conversion premium on the note. In July 1994, the Fund reduced its valuation to \$.15 based on continuing negative news. In the fall of 1994, the Fund sold its holdings of Margaux for \$.27 per share. On that basis, the original \$100,000 loan generated proceeds of \$180,000. The impact of the Fund's decision to loan Margaux \$100,000 on the value of its prior investment in Margaux cannot be determined.

The litigation: The SEC's position was that the Fund had violated the 1940 Investment Company Act by not using the current-sale methodology reflected in ASRs 113 and 118. The court found that the Parnassus board failed to act in good faith. It reached that conclusion based on lack of evidence in board minutes that the board had systematically discussed the difference between restricted and unrestricted share valuation and on other indications that the attention to the Margaux valuation was superficial.

The court rejected the Fund's position that the value of its holdings should not be constrained by market prices observed in an "illiquid" (pink sheet) market. It also rejected the Fund's position that there was no reason to discount the value of restricted shares, and accepted, instead, the SEC argument for a 50 percent discount. The court also rejected the board's argument for ascribing a conversion premium to the note.

⁴⁹ In August, 1990, Margaux was delisted from NASDAQ due to its negative net worth. After delisting,

The Fund based its valuation, in part on the prospect of outright sale of the company (rather than just the shares), and its potential to realize a control premium on its holdings. The court rejected sale-of-the-going-concern as a current sale methodology and rejected the control premium, as the Fund's total interest represented only about 15 percent of Margaux shares. The court also accepted the SEC position that the holdings should be discounted by an additional 25 percent due to market illiquidity.⁵⁰

Analysis: The case illustrates many of the problems identified in earlier discussion of the fair-value standard. First, Parnassus, like other open-end funds, as a matter of policy, did not generally invest in private equity or restricted shares. Parnassus acquired the shares in an effort to salvage its existing investment in Margaux and to capitalize on its prior experience with Margaux by investing on favorable terms. If, as the court finds, Parnassus erred, it did so as a result of having to apply a fair-value standard, when its primary focus was on holdings that are subject to market value determination. It is difficult to argue that Parnassus intended to deceive investors, as the Margaux position was small, and the effects of its valuation decisions on fund NAV value were slight. At any time between 1989 and 1994, writing off the entire convertible debt investment would have reduced NAV by less than three percent.

It is evident that the board repeatedly was involved in deliberations concerning fair value. At various times the board addressed the value of the conversion feature as an aspect of the debt investment, the effect of illiquidity on the value of registered shares, private information related to Margaux's prospects, the possible control premium

Margaux stock was quoted only in the Daily Quotation Bureau's "pink sheets."

⁵⁰ U.S. Securities and Exchange Commission, Administrative Proceeding File No. 3-9317, In the Matter of Parnassus Investments, December 3, 1998.

associated with its block-holding, and value in the event of an acquisition of Margaux by a third party. Also, the SEC's desire for certification was not accomplished by involving an auditor, as the auditor certified that the Fund had adhered to its valuation policies.

Instead, the administrative law judge ("ALJ") was in the position of making value determinations. The ALJ's valuations often were inconsistent with general market evidence. For example, the ALJ concluded that there could be no control premium because the Fund did not have a controlling interest. However, financial economics literature documents that a 15 percent equity interest can attract a control premium. In conjunction with other shares, 15 percent may be sufficient to determine control. Such an interest also often is sufficient to guarantee board representation.

The ALJ also accepted the SEC's argument for a 50 percent illiquidity discount, despite absence of evidence justifying the discount. The ALJ ignored the convertibility feature of the debt, treating the investment like common equity instead of a complex claim that would give Parnassus a preferential position in the event of Margaux's failure.

In the end, the Fund manager was forced to bear the cost of litigation, even when the court felt there was little to be gained. Despite the substantial investment of time on the litigation, the court ruling was a slap on the wrist with no precedent value. The ALJ saw no intent to deceive investors, and no significant reliance on the NAV distortions.⁵¹

B. Impact on Investment Practices of Closed-end Funds

The closed-end structure enables the manager to invest in illiquid assets and operate without providing for investor liquidity. The liquidity of fund assets is not directly

⁵¹"Respondents' actions did not involve fraud, but rather violations of technical provisions of the securities laws.... resulted in minimal harm to others and afforded them no unjust enrichment. Furthermore, prior

relevant to investors in closed-end funds because they are not relying on the primary market or on liquidity of fund assets for their own liquidity. Rather, they rely on whatever liquidity exists in the capital market for secondary transactions.

B1. Evidence that Closed-end Funds Avoid Restricted Shares

In contrast to open-end funds, the investment policies of closed-end funds are more varied. For example, the Royce Micro Cap Trust annual report emphasizes the value of closed-end structure for investing in securities with limited liquidity. Nonetheless, the fund limits itself primarily to investing in small capitalization registered shares. As of year-end 1997, Royce reported that only two securities, accounting for 0.62 percent of its assets, lacked readily available market quotations and required fair value determinations.⁵²

In contrast, Equus II, Inc. is a closed-end fund classified as a Business Development Company. The Equus II portfolio consists principally of securities that are subject to restrictions on resale, either because the security was acquired in private placement without registration or because the fund has a controlling interest in the company. Many of the fund's investments are in non-reporting companies. Virtually all of its holdings are subject to fair value determination.⁵³ Equus II is a significant exception to the normal investment practices of closed-end funds. Among 57 diversified equity closed-end funds identified in a 1999 *Wiesenberger Closed-End Weekly Review*, Equus II was the only fund with a significant fraction of fair-value assets.⁵⁴

to this proceeding, Respondents had never been the subject of an enforcement proceeding. Finally, I find the need for civil penalties to serve as a deterrent against future violation is wholly unnecessary.”

⁵² Royce OTC Micro Cap Fund, Inc., Form N-30D, December 31, 1997.

⁵³ Equus II, Inc., Form 10-K, December 31, 1996.

⁵⁴ *Review* dated June 18, 1999.

B2. Letter Stock Funds⁵⁵

Closed-end fund withdrawal from restricted investments is linked in time to the SEC's introduction of fair value certification and the current-sale principle. Between 1968 and 1969, six closed-end funds termed "Letter Stock funds" by the Wiesenberger Investment Company, were established with the specific purpose to invest in restricted securities, presumably motivated by profit opportunities in private equity. Information on the funds appears in Table 1.

As an example, one of the funds, the "Fund of Letters (the "Fund"), established a policy in 1968 that enabled it to invest up to 100% of total assets in restricted securities. The Fund intended to invest at least 80% of its assets in restricted securities, with at least 50% of its assets in restricted shares with a public, unrestricted market and no more than 25% in restricted shares without any publicly traded securities. The Fund's valuation policy did not conform with ASR guidelines: restricted stocks of public companies were valued based on the discount at purchase, other restricted shares were valued at cost.

Shortly after introduction of the ASRs, the Fund changed its investment policy and name, and became a target in litigation based on allegations of fraud relating to the valuation, and reporting of its restricted securities. During this same year, Wiesenberger (v. 1972, p. 24) highlighted concern about restricted stock valuations:

The restricted nature of the securities, however, does present a problem in pricing the portfolio. Here, the judgment of the fund's directors must determine the relationship to current market prices of unrestricted shares or the current value of securities for which no public market may exist. The problem, of course, is of much greater significance to an open-end company than it is to a closed-end fund.

⁵⁵ Recall that "letter stock" refers to the practice of attaching an investment letter to the security to substantiate the private offering exemption of the Securities Act. See note 7, *infra*.

Figure 1 illustrates that despite efforts by Letter Stock funds to make private equity investing available to the public, their investments in restricted stock declined systematically throughout the 1970s. Percentage allocations to illiquid investments decline from the 1969 high of 67 percent just after the introduction of the ASRs (1969 and 1970) and other valuation-related lawsuits were filed against the two largest Letter Stock funds, SMC Investment Corporation and Value Line Development Capital Corporation.⁵⁶

No large closed-end fund has since pursued this investment approach. Those that do invest in fair-value assets generally organize as BDCs and are too small to attract large investors and too small for the board's NAV determinations to create significant potential for litigation.⁵⁷ This is in sharp contrast to the venture capital market, which generated approximately \$50 billion in new capital commitments in 1999.

B3. Case Study: *In the Matter of R. Marvin Mears (1996)*⁵⁸

The SEC's case against a director of Corporate Capital Resources, Inc. ("CCRS") illustrates the risks of closed-end fund investment in restricted shares. CCRS was formed in 1988 and operated as a Business Development Company. It invested in shares of non-public companies and restricted shares of public companies, including high-risk companies that faced significant risk of failure. CCRS acquired its shares in privately-negotiated transactions. It valued its investments in restricted shares of public companies by applying discounts to bid-ask quotations reported in the National Quotation Bureau "pink sheets."

⁵⁶ SMC Investment Corporation (SMC) is a defendant in: *Orn v. Eastman Dillon, Union Securities Co.*, 364 F. Supp. 352 (C.D. Cal. 1973); Value Line Development Company is a defendant in: *In Re Value Line Special Situations Fund Litigation*, no. M 19-103 (S.D.N.Y. 1974).

⁵⁷ The SEC's EDGAR database indicates that 42 companies established themselves as BDCs between 1994 and mid-2000, and that 30 withdrew from BDC status. Currently, there appear to be 30 to 40 BDCs in existence; they are uniformly small.

This approach sometimes resulted in reporting an immediate gain, compared to the price CCRS paid for the shares. The Fund's President and Chairman of the Board valued the Fund's holdings and reported to the Valuation Committee of the Board on a quarterly basis. The "Investee Company Valuation Review" sheet for each company, showed the pink sheet quote and value calculation. With one exception, the Committee approved the valuations. Mears was a member of the Valuation Committee.

The Litigation: In this litigation, the SEC charged that CCRS had materially overstated the value of its holdings. As a member of the Valuation Committee, Marvin Mears was one of the individuals responsible for approving the valuations.

The SEC's position had three main elements relating to fair value certification: First, the SEC contended that the valuation methods used by the Fund "were improper...because CCRS did not value the shares at what it could realistically expect to realize upon their current sale." Second, the resulting valuations "were flawed" because "Pink sheet indications of interest were not firm as to any quantity, let alone the millions of shares owned by CCRS. The method wholly ignored the underlying financial condition and business prospects of the investment companies. Most were unprofitable and/or insolvent." Third, the Valuation Committee did not follow appropriate process because the "...Committee did not hold regular meetings, or conduct independent research, did not review any documents such as contracts, pricing information, or financial statements." The SEC argued: "Mears never dissented from a valuation supplied to the Valuation Committee," and that he knew that he was not examining "the proportion of the issuer's

⁵⁸ Securities and Exchange Commission, Administrative Proceeding File No. 3-8845, February 1996, In the Matter of R. Marvin Mears. The case was settled before reaching a verdict.

securities which are held by CCRS and the ability of CCRS to dispose of large blocks of securities in an orderly manner.”

Analysis: The Mears case illustrates the procedural focus of the SEC’s enforcement actions and the analytical focus on liquidation as the standard of value. Regarding the current-sale principle, the SEC rejects the notion that pink sheet quotes are appropriate as a basis for anchoring the valuation. In its view that such quotes are not firm offers to buy and CCRS’s holdings might be too substantial to liquidate easily. While the SEC proposes that large block size is a basis of an illiquidity discount, it ascribes no control premium to block holdings or to board representation. In noting that CCRS’s valuation approach does not directly consider the financial conditions of its portfolio companies, the SEC implies that pink sheet quotations are not an appropriate way to incorporate financial condition into a valuation.⁵⁹ The SEC’s rejection of the possibility of immediate increase in value after an investment is consistent with the current-sale principle. However, it may not be consistent with an alternative notion of fair value, such as going-concern value or value-in-use.

Despite regular meetings, the SEC argues that the Valuation Committee did not take seriously the Board’s responsibility as a certifier of value. The SEC apparently expects Committee members to do more than approve the computation of fair value; it seems to expect the Board or the Valuation Committee to engage in some activities that normally would be responsibilities of an auditor. For example, the SEC is critical of the Committee for not verifying security ownership or market quotations. In addition, the

⁵⁹ Though in the Parnassus case, it linked its valuation directly to pink sheet quotations for Margaux.

SEC implies that, unless the Valuation Committee regularly challenges the valuation conclusions of fund managers, it is not performing its function.

The SEC is critical of Mears because he personally did not dispute value conclusions presented to the Committee, did not seek verification of ownership, and did not challenge the fund's use of a valuation methodology that could result in value gains shortly after acquisition of a restricted-share position. Except for questions related to the validity of some of the Fund's share ownership claims, the SEC did not raise any issues with regard to the valuation of shares of non-public companies.

V. Remedies

A. The Under-diversification Problem

Because mutual funds generally do not invest in fair-value assets, individual investors are foreclosed from most participation in the markets for restricted shares, private equity, and venture capital. Foreclosure results in under-diversification.

Particularly with regard to venture capital, investment performance in recent years exemplifies the consequence of underdiversification. In 1999 and early 2000, many venture capital limited partnership funds earned high returns on their investments in Internet companies. Investors in the venture capital funds (primarily institutions other than mutual funds) often realized the returns through IPOs of the portfolio companies. Thus, the institutional investors in venture capital funds were able to lock-in high returns by selling in a market where individual investors could participate. Individual investors who wished to include Internet companies in their portfolios could only do so by exposing themselves to the risk that market valuations around the time of the IPOs were too high. Effectively, they were forced to bet against the venture capital funds that were selling.

Exposure to the risk of overvaluation could have been reduced had individual investors been able to use mutual funds to invest in Internet companies at earlier stages.

Investor demand to participate in a foreclosed portion of the capital market historically has driven policy change and capital market innovation. Fair-value certification, which triggered mutual fund withdrawal from investing in fair-value assets, appears now to be contributing to SEC policy changes and market innovations.

B. SEC Policy Responses

In 1992 the SEC adopted new rules to encourage mutual fund investment in fair-value assets and improve closed-end fund valuation.⁶⁰ In its accompanying release, the Commission noted that absence of mutual fund investment in restricted and illiquid securities was foreclosing investors from participation in those markets, stating, “Some recent developments have indicated that investors may not be able to satisfy their investment objectives with the traditional procedures for redeeming open-end shares and reselling closed-end shares.”⁶¹ For open-end funds, the Commission attributed lack of investment in illiquid assets to its seven-day redemption requirement, noting that fund liquidity needs could preclude investment. The 1992 changes allow open-end funds designated as “interval funds” or “extended payment funds” to provide intermediate levels of liquidity by taking longer to pay redemption proceeds.

The Commission recognized that its prior restrictions on open-end fund activity should increase investor reliance on closed-end funds. However, noting that closed-end

⁶⁰ Securities and Exchange Commission Release Nos. 33-6948 and 34-30967. 17 CFR Parts 239, 240, 270, and 274, “Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End Management Investment Companies and Registered Separate Accounts at Periodic Intervals or With Extended Payment,” August 6, 1992.

⁶¹ Ibid., Section I.B.

funds had not attracted new investment, the Commission expressed concern that one impediment to investment in private equity is that closed-end funds tend to sell at discounts. The 1992 rules provide that closed-end funds can respond to market undervaluation by tendering to repurchase their own outstanding shares at NAV. The rationale for the change was to enable managers to reduce or eliminate closed-end fund discounts by buying fund shares at NAV. The 1992 changes were intended to “facilitate greater investment in less liquid securities than is permitted for open-end companies, including venture capital investments, securities issues by small businesses, and less liquid securities issued by foreign issuers...”

There are other indications of SEC and legislative concern with the level of funds flowing into private equity. Congress, for example, liberalized regulations for BDCs twice, once in October 1980, “The BDC Act,” which also is referred to as the “Small Business Investment Incentive Act,” and again in 1996, under the “Market Improvement Act.”⁶² An SEC report, published in 1996, includes the following reference to valuation:

Congress should adopt amendments to the BDC provisions of the 1940 Act and the SEC should issue regulations removing the liability of BDC directors for the evaluation of portfolio investments especially for non-control investments in private companies. The BDC program would be more attractive if liability provisions were relaxed about the valuation requirements of illiquid investments. Clearer guidelines about such valuations would ease the impact of such provision as well.⁶³

Despite these intentions, the intended effects have not occurred. There has been no appreciable increase in open-end investment in restricted shares--the level still is essentially zero. Nor has closed-end fund investment in illiquid assets increased.

⁶² Complete reference

⁶³ Final Report of the SEC Government-Business Forum on Small Business Capital Formation, 1996.

The ineffectiveness of the 1992 changes is evidence that the focus of SEC changes was on the wrong problems. The SEC's open-end fund policy of reducing the need for liquidity can only affect investment in illiquid assets if liquidity concerns were constraining fund investment choices. However, as we have discussed, liquidity is not the central issue. Liquidity concerns could explain a *low level* of fund investment in restricted assets, but cannot not explain why funds *avoid* restricted shares altogether. The closed-end fund policy change, intended to reduce fund discounts, is only tangentially related to the kinds of investments a fund makes. A fund that is focused on fair-value assets potentially can limit the discount by valuing its investments conservatively, provided it is not concerned with litigation related to undervaluation.⁶⁴ Thus, permitting closed-end funds to tender at NAV is unlikely to motivate investment in fair-value assets.

C. Market-Based Innovations to Investor Demand

A recent capital market innovation, venture capital holding companies, enables investors to participate in the market for fair-value assets, but avoids exposure to the Investment Company Act and the current-sale principle. However, to avoid being classified as an investment company, the new holding companies sometimes must make investment decisions that are contrary to their business models.

CMGI, Inc., for example, describes itself as a developer and operator of Internet and fulfillment services companies. Incorporated in 1986, CMGI's business model is to add value to its portfolio companies by providing centralized services and by achieving

⁶⁴ Concern with litigation is legitimate. In 1998, a small open-end fund, IAI Value Fund, revalued a fair-value holding in a non-public company upward when the company registered for an IPO. The revaluation resulted in a 28 percent one-day return for fund investors. Investors who had sold before the revaluation filed suit against the fund, its managers, and board, contending the fund had been undervaluing the investment. See *Wall Street Journal*, 10/27,2000, at C19.

synergies among the companies. Accordingly, its investments are long-term in nature. As the portfolio companies mature, develop track records, and go public, CMGI's ability to add value can diminish. CMGI designates its investments in such seasoned companies as "available-for-sale securities." Thus, it draws a distinction between investments where it expects to continue involvement and those it seeks to harvest.

CMGI operates much like a closed-end fund organized as a business development company. It avoids being classified as a closed-end fund by limiting and categorizing investments in a way designed to keep it outside the investment company boundary.

Evidence of its concern with being classified as an investment company appears in a recent registration statement, where CMGI identifies the following "Risk Factor:"

WE MAY INCUR SIGNIFICANT COSTS TO AVOID INVESTMENT COMPANY STATUS AND MAY SUFFER ADVERSE CONSEQUENCES IF DEEMED TO BE AN INVESTMENT COMPANY....Some of our equity investments in other businesses and our venture subsidiaries may constitute investment securities under the Investment Company Act. A company may be deemed to be an investment company if it owns investment securities with a value exceeding 40% of its total assets, subject to certain exclusions....Although our investment securities currently comprise less than 40% of our total assets, fluctuations in the value of these securities or our other assets may cause this limit to be exceeded. Unless an exclusion or safe harbor was available to us, we would have to attempt to reduce our investment securities as a percentage of total assets. This reduction can be attempted in a number of ways, including the disposition of investment securities and the acquisition of non-investment securities assets. If we were required to sell investment securities, we may sell them sooner than we otherwise would. These sales may be at depressed prices and we may never realize anticipated benefits from, or may incur losses on, these investments. We may be unable to sell some investments due to contractual or legal restrictions or the inability to locate a suitable buyer.... We may also be unable to purchase additional investment securities that may be important to our operating strategy....⁶⁵

⁶⁵ CMGI, Inc., Form S-3 Registration Statement, filed September 11, 2000.

In contrast to mutual funds, CMGI accounts for its on-going investments in portfolio companies on a cost or consolidation basis. Only when it designates an investment in the restricted shares of a public company as an available-for-sale security does it revalue the investment at fair value. It determines fair value “based on quoted market prices, net of a market value discount to reflect any remaining restrictions on transferability.”⁶⁶ Thus, it bases valuation on an estimate of going-concern value and not on current sale. The discounts do not appear to incorporate market liquidity considerations or the size of the block that CMGI holds.

Idealab! is another company that is pursuing a strategy similar to that of CMGI. Expressing a similar risk consideration regarding its desire to avoid being classified as an investment company, idealab! states:

We may have to take actions, including buying, refraining from buying, selling or refraining from selling securities, when we would otherwise not choose to, in order to continue to avoid registration under the Investment Company Act. For example, we may have to ensure that we retain controlling ownership interests in our network companies after their initial public offerings, which would require us to expend significant amounts of capital that we might otherwise use to create or acquire other companies.⁶⁷

The Company’s preliminary registration statement includes a discussion of its valuation principles. Generally, valuations are tied to historical cost. In some cases, for non-public companies, idealab! adjusts carrying value based on third-party transactions pertaining to portfolio companies. For public companies, when restrictions on sale are for

⁶⁶ CMGI, Inc., Form 10-Q, filed August 16, 2000.

⁶⁷ Idealab! preliminary registration statement, Form S-1, dated April 20, 2000. As of this writing, the company’s registration was postponed due to a downturn in electronic commerce firm market values.

less than one year, idealab! relates valuation to the market price of unrestricted shares.⁶⁸

As with CMGI, its statements are not based on the current-sale principle.⁶⁹

D. Opportunities for Regulatory Reform

It is easy to understand why, in 1970, the SEC could conclude that certification was the most effective way to address perceived valuation abuses. The SEC's focus, at that time, was on individual investors who were making private decisions about value. The SEC's concern, as reflected in the ASRs, was that individual investors could be misled by manipulation of the valuations of restricted-share holdings. Investors necessarily based their decision on information that was significantly less complete and less timely than is possible today. Similarly, it is easy to understand why, at the time, the SEC could settle on the current-sale principle as a way to impose consistent and prudent valuation practices on investment companies.

However, improvements in technology and the corresponding ease with which individual investors can access information suggests that the protections are unnecessary and problematic. Practices in use by public holding companies suggest a two-pronged solution to mutual fund valuation concerns. First, investors often would be better served

⁶⁸ See idealab! Preliminary Registration Statement, Form S-1, dated April 20, 2000.

⁶⁹ A number of public corporations have established divisions or subsidiaries that invest in private companies. Intel, for example, makes strategic investments through its Intel Capital program. In 1999, its strategic equity portfolio was valued at \$8 billion, with marketable investments carried at market value and non-marketable investments carried at cost. In a manner similar to the holding companies, Intel can designate equity investments as "available-for-sale." Available-for-sale assets are carried at fair value. Marketable strategic investments that are available-for-sale are valued "based on quoted market prices." Those that are non-marketable are valued at lower of cost or market. The fair values of such investments are "estimated based on prices recently paid for shares in that company. No consideration is given to liquidity issues. The estimated fair values are not necessarily representative of the amounts that the company could realize in a current transaction." (See Intel Corporation Form 10-K, fiscal year ended December 25, 1999). Generally, venturing activities represent a small fraction of the total market value of the company and investors have no practical way to separate the two components of value.

by greater reliance on transparency and less on certification. Second, investors would be better served by allowing fund board more latitude in their valuation policies.

DI. Transparency v. Certification

As documented earlier, the same advances of modern portfolio theory and capital market efficiency that underlie “fraud on the market” theory, “truth-on-the market defense,” and the ERISA shift to the “Prudent Investor” standard, argue for greater reliance on transparency of reporting by mutual funds, and less reliance on certification.⁷⁰ Transparency requires simply that a fund disclose its holdings and describe them in terms of acquisition dates, original cost, restrictions on the holdings, and other possibly relevant information, and then allow the market to determine value.

Currently, most mutual funds report the details of their holdings only quarterly. NAVs, in contrast are reported more frequently, often daily. Current technology enables continuous reporting of NAVs, except with respect to fair-value holdings. Common practice is for funds to update the market value component of their NAVs daily, but to revise the fair value component only quarterly, or in response to identifiable occurrences that could materially change value. Current technology would enable funds to report changes in holdings daily or (if strategic concerns warrant) on a slightly delayed basis.

For restricted shares of public companies, a reasonable argument exists that, unless fund managers have private information about value, simply describing the holdings, the rights they convey, and their acquisition costs are all that the market needs to make its

⁷⁰ The fraud-on-the-market theory recognizes that most investors rely on the market to evaluate information for them, rather than rely on their own independent analysis of a stock’s value. See Sec. Reg. Fed, 69 A Am. Jur. 2d, § 1265-1270. The truth-on-the-market defense refers to a situation where investors had available to them all correct information regarding a company. Even if a company did not discuss the information, if credible news sources disseminated it, then it is presumed to be “known.”

own assessment of value. Whereas, withholding this fundamental information, and simply reporting the board's valuation and acquisition cost and identifying the securities as restricted, does not provide the market with the information it needs to make its own assessment.

For investments in venture capital and private equity, investors or analysts may demand more information than a fund is required to provide. The evidence of current practice by venture holding companies, however, demonstrates that even in the absence of regulations, firms are motivated to provide information the market demands. When managers believe the market does not recognize the value of company assets, they often respond by providing more information to the market. CMGI, for example, files audited financial statements of some of its subsidiaries with the SEC. The SEC, in turn, makes the statements accessible on the EDGAR system. In addition, CMGI recently decided to present its financial information on a more disaggregated basis.⁷¹ As recognized in the 1995 Private Securities Litigation Reform Act, insulating board, auditors, and others from liability for (non-fraudulent) forward-looking statements, thereby elevating transparency and narrowing the scope of certification, enables company boards to be more open with their disclosures. In an environment where undervalued companies can respond by providing more information, companies that withhold information are certain to be perceived negatively. There is no apparent reason why mutual funds, less fettered than they are today by the risks of fair-value certification and the current-sale principle, would not respond similarly to the market's demand for information.

⁷¹ To motivate the investment community to focus attention on specific business assets, some companies have introduced tracking stocks that are tied specifically to the performance of those assets.

By emphasizing certification over transparency, the ASRs rely on the court system instead of the market to discipline fund boards. However, as discussed above, the only cases likely to be heard are those where the SEC can demonstrate that the board's valuation procedures have been deficient. In such cases, the court is in the position of arbiter of fair value, a responsibility for which it often is not qualified.

D2. Fair Value and the Current-Sale Principle

Because it transacts continuously with investors, the management of an open-end fund cannot avoid reporting NAV on a continuing basis. However, the importance of fair value certification by open-end fund boards is limited because NAV is not the only information available to investors. Funds must periodically report their holdings and must disclose their valuation principles. Investors can easily discipline an open-end fund board that distorts its valuations of restricted shares. A board that overstates NAV, to an extent recognizable by analysts or investors, is likely to face net redemptions. If the board systematically overvalues the fund's holdings of restricted shares by, for example, arbitrarily and unjustifiably marking them to the market value of freely-tradable shares, investors will be net sellers and assets under management will decline.

Ironically, the current-sale principle is an impediment to transparency, particularly for open-end funds. If a fund is compelled to employ a valuation principle that is biased relative to the return it expects to realize, the market will exploit the incorrect valuation. With transparency, if investors or analysts recognize that NAV of an open-end fund is understated due to required adherence to the current-sale principle, the fund will attract capital as new investors attempt to free-ride on the real investment gains of current investors. Funds can prevent free-riding by avoiding or severely limiting investments in

fair-value assets (as is the current practice of open-end funds), by valuing them consistently with return expectations (which is not possible under current policy), or by imposing large transactions fees.

Transparency would discipline fund managers to limit investments in fair-value holdings. The larger and less diversified the stake as a percentage of total assets, and the more uncertain the valuations, the more incentive analysts have to search for value distortions. Consequently, large holdings of fair-value assets can contribute to fluctuations in the amount of capital under management, increasing the cost and difficulty of fund management. Transparency contributes to market discipline by making valuation errors easier to detect.

A closed-end fund is essentially a publicly owned company. However, in contrast to publicly owned companies, the fund must prepare its financial reports on the basis of liquidation value, and not on the basis of historical cost. For healthy public corporations, it is easy to see that liquidation value is not important to investors, who are attempting to determine going-concern value. Furthermore, corporate boards and managers explicitly seek to distance themselves from any role as certifiers of value by routinely including “forward-looking statement” disclaimers in their published documents.⁷²

For closed-end funds, allowing greater latitude in valuation of holdings would provide several benefits. First, it would enable funds to provide more relevant information to the market and reduce exposure to litigation risk. A closed-end fund that could follow the holding company practice of distinguishing between long-term investments and investments available for immediate sale, could limit certification risk exposure related to

long-term investments. It could accomplish this by simply carrying the assets at the lower of cost or established market, or by valuing restricted share holdings based on the market values of unrestricted shares, and allowing the market to make its own determination of value.

⁷² The 1995 Private Securities Litigation Reform Act protects managers of public corporations from liability for non-fraudulent forward-looking statements.

References

- Arneson, G. S., "Nonmarketability Discounts Should Exceed Fifty Percent," *Taxes* 59 (1981): 25-31.
- Barth, Mary and Wayne Landsman, "Fundamental Issues Related to Using Fair Value Accounting for Financial Reporting," Stanford University Research Paper #1345, (September 1995).
- Beaver, W. H., Financial Reporting: An Accounting Revolution, Prentice Hall: Englewood Cliffs (1987)
- Blackwell, David and David Kidwell, "An Investigation of the Cost Differences Between Public Sales and Private Placement of Debt," *Journal of Financial Economics* 22 (1988): 253-78.
- Brickley, James, Steven Manaster, and James Schallheim, "The Tax-Timing Option and the Discounts on Closed-End Investment Companies," *Journal of Business* 64 (1991): 287-312.
- Cornell, Bradford, Corporate Valuation, New York: Mc-Graw-Hill (1993).
- Hertzel, Michael and Richard L. Smith, "Market Discounts and Shareholder Gains for Placing Equity Privately," 48 *Journal of Finance* (1993): 459-485.
- Krishnamurthy, Srinu, Paul Spindt, Venkat Subramaniam, and Tracie Woidtke, "Does Equity Placement Type Matter? Evidence from Long-term Stock Price Performance Following Private Placements," working paper (1999).
- Lee, Charles, Andrei Schleifer, and Richard Thaler, "Investor Sentiment and the Closed-End Puzzle," *Journal of Finance* 46 (1991): 76-110.
- Longstaff, Francis, "How Much Can Marketability Affect Security Values?" *Journal of Finance*, 50 (1995): 1767-1774.
- Modernizing U.S. Securities Regulations: Economic and Legal Perspectives, Kenneth Lehn and Robert W. Kamphuis, Jr. Eds, New York: Irwin (1992).
- Nanda, Vikram, M.P. Narayanan, and Vincent A. Warther, "Liquidity, Investment Ability, and Mutual Fund Structure," *Journal of Financial Economics* 57 (2000): 417-443.
- Pontiff, Jeffrey, "Closed-End Fund Premia and Returns: Implications for Financial Market Equilibrium," *Journal of Financial Economics* 37 (1995): 341-370.

Ritter, Jay R., "The Costs of Going Public," *Journal of Financial Economics*, 19 (1987): 269-281.

Silber, William, "Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices," *Financial Analysts Journal*, July-August (1991): 60-64.

Securities and Exchange Commission, "Discounts Involved in Purchases of Common Stock," *Institutional Investor Study Report of the Securities and Exchange Commission* (Washington, D.C.: U.S. Government Printing Office, 1971).

Thompson, Rex, "The Information Content of Discounts and Premiums on Closed-End Fund Shares," *Journal of Financial Economics* 6 (1978): 151-186.

Weiss, Kathleen, "The Post-Offering Price Performance of Closed-End Funds," *Financial Management* 18 (1989): 57-67.

Wruck, Karen, "Equity Ownership Concentration and Firm Value: Evidence from Private Equity Financings," *Journal of Financial Economics*, 23 (1989): 3-28.

Table 1

Table 1 shows total NAV in millions and the percent of NAV invested in restricted securities and venture capital (Pct. Illiquid) for closed-end funds that are designated as “Letter Stock Funds” in Wiesenberger Investment Companies (WIC) for the years ending 1968-1979.

	Year Formed	Investment Type	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Diebold Tech.	1968	NAV	28.4	26.2	16.2	14.9	16.3	12.9	8.9	11.6	13.6	14.7	16.1	23.6
Venture Fund ¹		Pct.	16.0%	54.8%	75.9%	75.8%	82.9%	87.2%	76.8	74.3%	41.3%	30.6%	23.3%	36.8%
		Illiquid							%					
Fund of Letters ²	1968	NAV	31.1	34.3	24.0	29.2	27.5	18.6	17.3	19.9	23.9	32.5	44.8	52.9
		Pct.	56.0%	86.0%	90.1%	58.5%	25.5%	17.7%	16.1	27.8%	11.8%	9.8%	17.3%	11.1%
		Illiquid							%					
Inventure Capital Corporation ³	1969	NAV			10.1	10.5	11.4	7.9	2.2					
		Pct.			26.0%	26.7%	31.4%	20.5%	20.5%					
		Illiquid												
Price Capital Corporation ⁴	1969	NAV		15.0	9.2	11.0	9.0	5.3	4.6	5.9	8.0	11.5	9.6	12.5
		Pct.		16.9%	38.4%	44.2%	34.1%	31.4%	20.9	13.4%	3.4%	4.8%	4.8%	4.8%
		Illiquid							%					
SMC Investment Corporation ⁵	1968	NAV			192.8	202.5	210.0	180.3	137.3	150.5	160.4	165.8	175.5	198.6
		Pct.			55.5%	47.4%	49.0%	47.2%	40.3	28.2%	26.5%	14.8%	7.0%	3.4%
		Illiquid							%					
Value Line Dev. Capital Corp.	1968	NAV	29.6	35.8	27.2	30.5	23.4	14.5	10.6	10.3	10.3	9.8	9.7	10.8
		Pct.	75.0%	79.0%	81.1%	82.0%	83.1%	75.9%	73.7	66.5%	59.1%	48.5%	35.8%	20.3%
		Illiquid							%					
Total of all		NAV	89.1	111.3	279.5	298.6	297.6	239.5	180.9	198.2	216.2	234.3	255.7	298.4
		NAV	44.2	74.7	169.1	157.0	149.5	113.9	74.2	64.2	57.3	37.5	27.7	24.1
		Pct.							41.0					
		Illiquid	49.6%	67.1%	60.5%	52.6%	50.2%	47.6%	%	32.4%	26.5%	16.0%	10.8%	8.1%

¹ renamed Claremont Capital Corporation in 1977

² renamed New America Fund in 1971

³ renamed Emerging Securities Fund in 1974

⁴ renamed Highland Capital Corporation 1972

⁵ renamed Source Capital 1973

Source: Wiesenberger Investment Companies, Mutual Funds and Other Types, v. 1969-1980. Italicized figures are not available. Percentages are assumed to be the same as in the prior year.

Total NAV and Restricted Share NAV of "Letter Stock Funds"

