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

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# THE SEC'S "FAIR VALUE" STANDARD FOR MUTUAL FUND INVESTMENT IN RESTRICTED SHARES AND OTHER ILLIQUID SECURITIES\*

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## INTRODUCTION

Mutual funds generally do not invest in venture capital, private equity, or restricted shares of public companies.<sup>1</sup> Consequently, individuals who desire to invest in such securities are unable to do so through their investments in diversified mutual funds. While limited partnerships 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 these securities in closed-end and open-end funds. 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

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1. See 17 C.F.R. § 270.2a-4 (2001). Valuation requirements under the statute discourage investment in these types of assets. *Id.*

exposing mutual fund investors to excessive risk or potential manipulation.

The Investment Company Act of 1940 (the "Act" or the "1940 Act")<sup>2</sup> establishes rules and procedures for forming and operating closed-end and open-end funds.<sup>3</sup> 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.<sup>4</sup> Rule 2a-4(a)(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 . . . ."<sup>5</sup>

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.<sup>6</sup> Acting under this authority, in 1969 the Commission issued Accounting Series Release No. 113 ("ASR 113").<sup>7</sup> One year later, in 1970, it issued Accounting Series Release 118 ("ASR 118").<sup>8</sup> 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.<sup>9</sup>

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2. Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq.* (2000).

3. *Id.*

4. 15 U.S.C. §§ 80a-22 *et seq.* (2000)

5. 17 C.F.R. § 270.2a-4(a)(1) (2001).

6. 15 U.S.C. §§ 80a-1 *et seq.*

7. Statement Regarding "Restricted Securities", Accounting Series Release No. 113, Investment Company Act Release No. 5847, [1937-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,135, at 62,283-62,288 (October 21, 1969) [hereinafter ASR 113].

8. Accounting for Investment Securities by Registered Investment Companies, Investment Company Act Release No. 6295, [1937-1982 Transfer Binder] SEC Accounting Rules Fed. Sec. L. Rep. (CCH) ¶ 72,140, at 62,293-62,298 (December 23, 1970) [hereinafter ASR 118].

9. See ASR 113, *supra* note 7; see also ASR 118, *supra* note 8. In December 1999 and April 2001, the SEC division of Investment Management reinforced the Commission's prescription in ASR 113 and 118 in letters to the Investment Company Institute ("ICI"). Letter from the Division of Investment Management to the ICI Regarding Valuation Issues (Dec. 8, 1999) [hereinafter 1999 Letter];

The Act and the ASRs establish a fair value "certification standard," where mutual fund boards are required to make good-faith fair-value determinations.<sup>10</sup> The SEC requires boards to produce and maintain records of their valuation policies, deliberations, and conclusions, and to preserve the records for audit.<sup>11</sup> The board "certifies" the values of the illiquid assets and the auditor "certifies" the board's adherence to its valuation policies.<sup>12</sup> The SEC constrains good faith valuation by requiring that fair value be based on "value in current sale," fundamentally a liquidation value principle.<sup>13</sup>

We present evidence that, following these changes in SEC policy, closed-end funds, in particular, retreated from investment in illiquid equity securities.<sup>14</sup> Mutual fund investment in illiquid equity has remained low, despite recent rapid growth in the markets for venture capital and private equity.<sup>15</sup> 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 thirty years old.<sup>16</sup> 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 financial economic theory, capital market evidence, and legal theory applied in other settings (such

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Letter from the Division of Investment Management to the ICI Regarding Valuation Issues (April 30, 2001) [hereinafter 2001 Letter]. The Investment Company Institute is an industry association representing over 9,000 open-end and close-end mutual fund. See

[http://www.ici.org/about\\_ici.html](http://www.ici.org/about_ici.html) (last visited Sept. 27, 2001).

10. See 15 U.S.C. §§ 80a-1 *et seq.* (2000); ASR 113, *supra* note 7; ASR 113, *supra* note 8.

11. See 15 U.S.C. §§ 80a-1 *et seq.*; ASR 113, *supra* note 8.

12. 17 C.F.R. § 270.2a-4 (2001).

13. ASR 113, *supra* note 7.

14. See *infra* Part IV.B.2.

15. *Venture Capital - Money to Burn*, THE ECONOMIST, May 27, 2000 at 71; RICHARD SMITH & JANET KIHOLM SMITH, ENTREPRENEURIAL FINANCE 497 (John Wiley 2000).

16. See ASR 113, *supra* note 7; ASR 113, *supra* note 8. ASR 113 and 113 were passed in 1969 and 1970, respectively.

as in fraud-on-the-market cases).<sup>17</sup> 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.<sup>18</sup> 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<sup>19</sup> and the Securities Exchange Act of 1934<sup>20</sup> are the principal federal statutes that control public sale and distribution of securities. The Securities Act relates primarily to initial issuance and the Exchange Act relates primarily to subsequent trading.<sup>21</sup> Under the Securities Act, issuers of

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17. See Mark Mitchell & Jeffrey Netter, *The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission*, 49 *BUS. LAW.* 545 (1994) (providing a general review of financial economic theory and evidence, and applications in securities litigation).

18. 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.

19. The Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.* (2000).

20. The Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.* (2000).

21. JAMES D. COX ET AL., *SECURITIES REGULATION 3-9* (Richard A. Epstein et al. eds., Aspen Law & Business 2d ed. 1997).

registered shares sell to investors via a prospectus that contains SEC-prescribed information about the issuer and the offering.<sup>22</sup> 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.<sup>23</sup>

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.<sup>24</sup> However, the 1933 Act recognizes that private transactions among sophisticated investors do not require the same level of oversight.<sup>25</sup> Accordingly, it exempts from registration "transactions by an issuer not involving any public offering."<sup>26</sup>

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.<sup>27</sup> 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.<sup>28</sup> Subsequently, Rule 144 formalized a safe harbor that could be used to meet the "investment purpose" requirement.<sup>29</sup> 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.<sup>30</sup> Because of these

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22. 15 U.S.C. §§ 77aa (2000).

23. The Securities Exchange Act, §§ 77a *et. seq.*.

24. COX, *supra* note 21, at 3-9.

25. 15 U.S.C. § 77d.

26. *Id.*

27. 17 C.F.R. § 230.144 (2001).

28. *Id.*

29. *Id.*

30. *Id.* Rule 144 was enacted in 1972 and was anticipated in the drafting of

restrictions on resale, privately placed unregistered shares of public companies are referred to as “restricted shares.”<sup>31</sup>

*B. The Investment Company Act of 1940*

The Investment Company Act of 1940<sup>32</sup> 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.<sup>33</sup> 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<sup>34</sup> and 118.<sup>35</sup> It did so in response to the fact that some closed-end and open-end funds were acquiring material

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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 an “affiliated investor” of the issuing firm. *Id.* Affiliates are subject to Rule 144’s volume limitations even as to their unrestricted securities. *Id.* Moreover, it makes no difference how long their “holding period” is. *Id.* The concept of holding period applies to affiliates only in the negative sense that they cannot sell restricted securities until they have held them for the requisite holding period, which is the same as the holding period for everybody else (1 year). *Id.*

31. 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. FREDRICK D. LIPMAN, *GOING PUBLIC* (1994); ASR 113, *supra* note 7, 62,284. This serves to substantiate that the transaction is within the “private offering exemption” from registration under 4(2) of the Securities Act. *Id.* The term “restricted shares” is sometimes used more broadly to include shares of non-public companies. We refer to shares of non-reporting companies as private equity.

32. 15 U.S.C. §§ 80a-1 *et seq.* (2000).

33. *Id.*

34. ASR 113, *supra* note 7.

35. ASR 118, *supra* note 8.

holdings of restricted shares.<sup>25</sup> In ASR 113, the Commission states that, "[f]or 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."<sup>37</sup> Open-end companies accounted for about \$3.2 billion of these restricted securities which represented 4.4 percent of their total net assets."<sup>33</sup>

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.<sup>39</sup> In it, the Commission points to "competitive pressures on portfolio managers to improve investment performance,"<sup>40</sup> and states, "[o]ne 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."<sup>41</sup> 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).<sup>42</sup> Investments by survey respondents in such securities increased by ninety-one percent from 1966 to 1967, and by 315% from 1967 to 1968; an overall increase of 694% from the 1966 base.<sup>43</sup> In 1968 mutual funds accounted for twenty-nine percent of institutional investment in illiquid equities, compared to thirteen percent in 1966.<sup>44</sup> The study expressed concern that the mutual fund investments were concentrated among a few funds.<sup>45</sup> In the SEC's sample, five open-end funds that were early movers

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36. *Id.*; ASR 113, *supra* note 7.

37. ASR 113, *supra* note 7.

38. *Id.*

39. Securities and Exchange Commission, *Institutional Investor Study Report of the Securities and Exchange Commission*, (U.S. Government Printing Office Washington, 1971) (available on file at the Journal of Corporate and Financial Law) [hereinafter SEC study].

40. *Id.*

41. *Id.* at xiii.

42. *Id.*

43. *Id.* at 2400.

44. *Id.* at 2420 (Absolute dollar investment declined in 1969, possibly as an effect of SEC valuation policies under ASR 113.).

45. *Id.* at 2400.



into the market accounted for 83.7% of surveyed holdings.<sup>46</sup> The study also notes that institutions were following divergent valuation practices, and identified this as a basis for concern.<sup>47</sup>

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 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."<sup>48</sup> The SEC notes that fund managers who are compensated on the basis of NAV or performance can succumb to incentives to overvalue their holdings.<sup>49</sup> Further, the SEC expresses its concern that overvaluing illiquid equity holdings can mislead investors.<sup>50</sup>

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.<sup>51</sup> "For valuation purposes, therefore, restricted securities constitute securities for which market quotations are not readily available."<sup>52</sup>

Noting that restricted securities often are purchased at discounts relative to the market price of unrestricted securities, the

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46. *Id.* at 2494.

47. *Id.* at 2473. In the study, thirty-three percent of dollar-valued holdings were carried at the current market price of freely traded shares less a discount, 41 percent were carried at the current market price of unrestricted shares, 5 percent were carried at acquisition cost, and twenty-one percent were carried at other values. *Id.*

48. ASR 113, *supra* note 7, at 62,284. The offering price of securities issued by a management investment company is based on the net asset value. The improper valuation of restricted securities would alter the net asset value of the shares offered or, in the case of an open-end company, redeemed, and therefore constitutes a fraud and deceit within the meaning of Section 10(b) and Rule 10b-5. *Id.*

49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

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.<sup>53</sup>
- 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.<sup>54</sup> 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.<sup>55</sup>

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.<sup>56</sup> 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."<sup>57</sup> In the view of the SEC, such approaches are inconsistent with "good faith."<sup>58</sup> Nor may a fund rely on mechanical or formulaic amortization of the

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53. *Id.*

54. *Id.*

55. *Id.* As a general principle, the current fair value of restricted securities would appear to be the amount that 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 that holds restricted securities.

56. *Id.*

57. *Id.*

58. *Id.* at 62,283-84.

restricted share discount at the time of the fund's investment in the shares.<sup>59</sup> In taking this position, the SEC precluded reliance on any of the valuation approaches that were in common use by funds.<sup>60</sup>

More fundamentally, the SEC suggests that any approach that relates restricted-share value to the market value of unrestricted shares can be problematic.<sup>61</sup> ASR 113 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.<sup>62</sup>

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59. *Id.* at 62,284-85.

[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.

*Id.*

60. See ASR 113, *supra* note 7.

61. *Id.*

62. *Id.* This concern may reflect the now documented finding that, on average, share prices of public companies increase when companies place equity privately. Karen Hopper Wruck, *Equity Ownership Concentration and Firm Value*, 23 J. FIN. ECON. 3 (1989); Michael Hertzler & Richard Smith, *Market Discounts and Shareholder Gains for Placing Equity Privately*, 48 J. FIN. 459, 459 (1993); Srinivasan Krishnamurthy, Paul Spindt, Venkat Subramaniam & Tracie Woidtke, "Does Equity Placement Type Matter? Evidence from Long-term Stock Price Performance Following Private Placements," working paper (1999) (available on file with the Fordham Journal of Corporate and Financial Law). 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. ASR 113, *supra* note 7. In contrast, the financial economics literature suggests the unrestricted share price increase can be a rational market response to news of private investment. Wruck, *supra* note 61; Hertzler & Smith,

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.<sup>63</sup>

ASR 118 reiterates the discussion from the earlier release—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.<sup>64</sup>

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*supra* note 61; Krishnamurthy et al., *supra* note 61. 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.

63. ASR 113, *supra* note 7.

64. See ASR 118, *supra* note 8, at 62,294-96.

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 disclosed. In addition, any deviation from a stated valuation policy should be disclosed. 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 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 trading in similar securities of the issuer or comparable

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.<sup>65</sup> The implicit regulatory theory of certification is that litigation risk creates incentives for the board and auditor to provide reliable valuations. 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,”<sup>66</sup> but the Commission does not distinguish between the differing roles of NAV to closed-end and open-end funds.<sup>67</sup> 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.<sup>68</sup> Investors in open-end funds always transact directly with the fund at NAV per share.<sup>69</sup>

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companies, and other relevant matters.

*Id.*

65. ASR 118, *supra* note 8; ASR 113, *supra* note 7.

66. ASR 113, *supra* note 7, at 62,283-84.

67. *Id.*

68. *See id.* at 62,284. ASR 113 lists special factors that relate only to open-end companies, [illustrating that] . . . it is desirable that an open-end company retain maximum flexibility in the choice of portfolio securities which, on the basis of their relative investment merits, could best be sold where necessary to meet redemptions. To the extent that the portfolio consists of restricted securities, this flexibility is reduced.

*Id.*

69. *See* Kathryn Haines, *Closed-End Funds*, Morningstar.com (Jul. 15, 2000), at <http://news.morningstar.com/news.com/news/MS/Funds/101/closedend.html>; BARRON’S DICTIONARY OF FINANCE AND INVESTMENT TERMS 413 (John

New investments create new fund shares and increase the fund's capital under management.<sup>70</sup> Sales of shares are treated as 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 will be overstated and fund investors will pay too much. The SEC's apparent concern is primarily with positive distortions of NAV.<sup>71</sup>

In a closed-end fund, the manager raises capital through selling publicly tradable shares.<sup>72</sup> This is a primary market transaction.<sup>73</sup> Anyone who wishes to invest in the fund after the offering can do so only by exchanging already outstanding shares with another investor.<sup>74</sup> This secondary market transaction generates no new capital for the fund.<sup>75</sup>

Because closed-end fund shares trade in the secondary market, their market values can differ materially from reported NAV.<sup>76</sup>

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Downes & Jordan Elliot Goodman eds., *Barron's Educational Series*, 5th ed. 1998) (stating that open-end fund shareholders buy shares at NAV, as well as defining the share price of open end funds as NAV); Jeffrey Pontiff, *Closed-end Fund Premia and Returns Implications for Financial Market Equilibrium*, 37 J. FIN. ECON. 341, 341-370 (1995) ("Unlike open-end funds, which trade their shares at the net asset value of their portfolio, closed-end fund shares are traded on an exchange."); RICHARD J TEWELES & EDWARD S. BRADLEY, *THE STOCK MARKET* 413 (Wiley Investment, 7 ed. 1998) (stating that closed end funds fund prices have no direct relation to NAV).

70. See Haines, *supra* note 69; BARRON'S, *supra* note 69, at 412 (explaining that, by definition, the open-ended management company continually create new shares on demand).

71. *Id.*

72. See TEWELES & BRADLEY, *supra* note 69, at 413.

73. *Id.*

74. *Id.*

75. *Id.*

76. Haines, *supra* note 69, at 1-2. Of the 500 closed-end funds covered by Wiesenberger in their 1999 survey, fourteen percent were equity funds. See WIESENBERGER INVESTMENT COMPANY SERVICES, *INVESTMENT COMPANIES YEARBOOK* 2000 30 (2000). On average, approximately seventy-five percent of the closed-end funds traded at a discount in 1999, with an average discount of 5.73%. *Id.* 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. SEC rules permit closed-end funds periodically to repurchase

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.<sup>77</sup> 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.<sup>78</sup> 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.

### B. How Illiquidity Affects Value

Other things being 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. Third, in light of the first two issues, is current sale value the economically correct standard to use for

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shares at NAV, but do not require them to do so. Generally, the funds do not repurchase shares.

77. See Haines, *supra* note 69, at 2. For a discussion of closed-end fund discounts, see James Brickley, Steven Manaster & James Schallheim, *The Tax-timing Option and the Discounts on Closed-End Investment Companies*, 64 J. BUS. 287, 288 (1991); Charles M. C. Lee, Andrei Schleifer & Richard Thaler, *Investor Sentiment and the Closed-End Fund Puzzle*, 75 J. FIN. 1 (1991); Haines, *supra* note 69; Kathleen Weiss, *The Post-Offering Price Performance of Closed-End Funds*, 18 FIN. MGMT. 57 (Autumn 1989).

78. See Brickley, *supra* note 77, at 291.

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<sup>77</sup>, that difference need not result in a material difference in value.<sup>81</sup> 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 disadvantage the investor. This principle is implicit in the portfolio investment decisions of institutional investors.<sup>81</sup> Open-end funds often formally limit their maximum investments in illiquid and restricted shares to levels where fund redemptions would not require liquidating such shares.<sup>82</sup> Closed-end funds can, in principle, invest more aggressively in illiquid and restricted securities, as they do not face the same liquidity concerns.<sup>83</sup> 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.<sup>84</sup>

Investors in restricted shares seek to earn return premiums by investing in illiquid assets.<sup>85</sup> Two factors contribute to the potential premium. The first is the supply of and demand for funds available

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79. See BARRON'S, *supra* note 69, at 321 (explaining that a letter security cannot be sold in the public markets).

80. See William L. Silber, *Discounts on Restricted Stock: The Impact of Illiquidity on Stock Prices*, FIN. ANALYSIS J. 60, 61 (Jul.-Aug. 1991) (explaining that sometimes restricted shares sell at a premium due to control rights such as the right to make appointments to the board of directors).

81. See JAMES L. FARRELL, JR., *PORTFOLIO MANAGEMENT: THEORY AND APPLICATION* (1997).

82. Actual holdings of illiquid equity securities are substantially below the formal limits. MORNINGSTAR, *supra* note 144.

83. See Haines, *supra* note 69, at 3.

84. TEWELES & BRADLEY, *supra* note 69, at 413-416 (outlining the liquidity structures and strategies for open-end and closed-end funds).

85. Hertzell & Smith, *supra* note 62.



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.<sup>86</sup> The return premium is a gain the investor may capture by virtue of its prior (sunk) investment in information about the issuer. This return is actually a quasi-rent associated with the pre-existing informational advantage of the investor.<sup>87</sup> It is not a market return for bearing illiquidity risk.<sup>88</sup>

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.<sup>89</sup> Economic theory provides no basis to expect a large return premium for bearing illiquidity risk. This is because many

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86. *Id.*

87. PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* (1992).

88. 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.

89. 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.

institutional investors can make restricted share investment without materially affecting their overall liquidity. Such investors therefore require only 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.<sup>90</sup> Thus, low transaction prices for restricted shares and other illiquid assets cannot be driven by institutional investors' liquidity needs.<sup>91</sup> Nor can large discounts be driven by the value of foregone put options that marketable shares provide. Without 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.<sup>92</sup>

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90. MORNINGSTAR, *infra* note 144.

91. 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).

92. 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 derives upper bound estimates on the value of liquidity to an investor who has perfect market timing ability. Francis A. Longstaff, *How Much Can Marketability Affect Security Values?*, 50 J. FIN. 1767, 1767 (1995). He concludes that the value of liquidity to such an investor can be substantial. *Id.* 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. *Id.* 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.

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.<sup>93</sup> 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 variations in discounts associated with placements of restricted securities.<sup>94</sup> A useful place to begin is with the 1988 Blackwell and Kidwell study of relative costs of publicly-issued and privately-placed debt.<sup>95</sup> They examine expected yields on net proceeds for firms that switched between public issues and private placements.<sup>96</sup> Despite legal restrictions on resale of unregistered debt, they find no significant difference in yield on net proceeds between private and public issues.<sup>97</sup> 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.<sup>98</sup> For the issuers in the Blackwell and Kidwell study, informational concerns were of high importance, as the firms were

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93. Hertzelt & Smith, *supra* note 62.

94. *Id.*; Silber, *supra* note 80.

95. David W. Blackwell & David S. Kidwell, *An Investigation of Cost Differences Between Public Sales and Private Placements of Debt*, 22 J. FIN ECON 253, 253-279 (1988).

96. *Id.* Blackwell and Kidwell base their study on data from before enactment of Rule 144A. *Id.* 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. 17 C.F.R. § 230.144A.

97. *Id.* at 272.

98. *Id.* at 273.

all issuers of investment grade debt.<sup>99</sup> Correspondingly, the private placement discounts were negligible.<sup>100</sup>

There have been many studies of equity private placements.<sup>101</sup> All find that, on average, the discounts relative to registered shares, are substantial.<sup>102</sup> More detailed examination demonstrates that most of the discount is related to informational concerns, and not directly to illiquidity.<sup>103</sup> In their 1993 study of equity private placements, Hertz and Smith find that the size of the discount is related to the cost of becoming informed about the value of the securities.<sup>104</sup> 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 distress.<sup>105</sup> They estimate that the effect of restricted trading on the discount is 13.5% of the value of unrestricted shares.<sup>105</sup> Even for shares that are not restricted,

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99. *Id.*

100. *Id.*

101. See Silber, *supra* note 80; Hertz and Smith, *supra* note 62.

102. In its sample from the late 1960's, the SEC estimated that the average restricted share discount was 23.1%, measured against the "ask" price for unrestricted shares. SEC Study, *supra* note 39. For a sample of small private placements from the 1980s Silber reports an average discount of 33.75%, measured against closing price on the placement date. Silber, *supra* note 80. For a sample of large private placements of unregistered shares by exchange-listed firms, from 1979 through the mid-1980s Wruck finds an average discount of 13.5%. Wruck, *supra* note 62. Using a sample of private placements from the 1980s Hertz and Smith find that the average discount on placements of restricted shares was forty-two percent, measured against the market closing price ten days after the placement, which corresponds to a discount of thirty-three measured against the market closing price three days before the placement. Hertz and Smith, *supra* note 62. For a sample of restricted shares from the 1980's and early 1990's, Krishnamirty, Srinivasan, Spindt, Subramanian and Woidtke find a discount of 34.02%, measured against market closing price ten days after the placement. Krishnamirty, et al., *supra* note 62. Some argue that the private placement evidence supports discounts in excess of fifty percent. See G.S. Arneson, *Non-Marketability Discounts Should Exceed Fifty Percent*, 59 TAXES 25, 25-31 (1981).

103. Hertz and Smith, *supra* note 62.

104. *Id.*

105. *Id.*

106. *Id.*; see Revision of Holding Period Requirements in Rule 144; Section 16(a) Reporting of Equity Swaps and Other Derivative Securities, Securities Act Release No. 33-7187, Exchange Act Release No. 34-35,896, 60 Fed. Reg. 35,645

discounts range from very large to zero or even slight premiums.<sup>107</sup> 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, to the quasi-rents derived from an investor's ongoing involvement with the issuer, and to the urgency of the issuer's need for liquidity.<sup>108</sup>

Silber finds that restricted share discounts are inversely related to the issuer's credit worthiness<sup>109</sup> and finds some cases of restricted shares being sold at premiums.<sup>110</sup> He ascribes premiums to considerations such as board representation, and factors that receive little attention in the ASRs.<sup>111</sup> Krishnamurthy, et al. find a similar overall result. In their sample, the average discount is 10.7% 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.<sup>112</sup>

#### 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.<sup>113</sup> Reliance on

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(Jun. 27, 1995); Revision of Holding Period Requirements in Rules 144 and 145 from February 1997. *Id.* If illiquidity caused by resale restrictions contributes to returns, then opportunities to benefit significantly by investing in restricted securities may not persist. Hertz and Smith, *supra* note 62. The Rule 144 restriction period recently was reduced from two years to one. *Id.* With the supply of restricted securities constant, this change effectively doubles the flow of funds available for restricted-security investment. *Id.*

107. See Hertz and Smith, *supra* note 62.

108. *Id.*

109. Silber, *supra* note 80, at 60-62.

110. Several studies of the discount find that some restricted and unrestricted shares are placed privately at premiums. See SEC Study, *supra* note 39; Hertz and Smith, *supra* note 62; Silber, *supra* note 80, at 63.

111. Silber, *supra* note 80, at 61.

112. Krishnamurthy et al., *supra* note 62.

113. ASR 113, *supra* note 7.

market prices in 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." 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.<sup>114</sup> In SFAS 107, fair value is the exchange value of an asset in a current transaction between willing parties, other than in forced liquidation.<sup>115</sup> As Barth and Landsman note, depending on how investors use the information, entry value, exit value, and value-in-use all are reasonable constructs of fair value.<sup>116</sup> 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.<sup>117</sup>

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. Customary accounting definitions, like the SEC definition, make

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114. American Institute of Certified Public Accountants, Inc., *Statement of Financial Accounting Standards No. 107 - Disclosures About Fair Value of Financial Instruments*, 5-92 J.A. 139 (1992).

115. See Mary E. Barth & Wayne R. Landsman, *Fundamental Issues Related To Using Fair Value Accounting for Financial Reporting*, 9 ACCT. HORIZONS 4, 99 (Dec. 1995).

116. *Id.*

117. W. H. BEAVER, *FINANCIAL REPORTING: AN ACCOUNTING REVOLUTION* (1987).

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.<sup>118</sup>

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 securities 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.<sup>119</sup> 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.<sup>120</sup> 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.<sup>121</sup> However, from a financial 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

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118. ASR 113, *supra* note 7.

119. Hertzels & Smith, *supra* note 62, at 462-463.

120. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 61-83 (6th ed. 2000).

121. ASR 113, *supra* note 7, at 62,284.

purchase.<sup>122</sup> This is because, at the time of purchase, the fund realizes the benefits of incurring due diligence costs and other costs of discovering the value of the restricted security. These costs are reflected in a lower 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.<sup>123</sup> Underwriters, board members, and others effectively certify the representations contained in offering prospectuses and the absence of material omissions.<sup>124</sup> 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. Given that the technology to transmit detailed information to investors about fund holdings has improved dramatically 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

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122. Hertzell & Smith, *supra* note 62, at 462-463.

123. See Valerie Ford Jacob, *Understanding the Securities Laws 2000 - Registration and Reporting Under The Securities Exchange Act of 1934*, 1198 *PLI/Corp* 415, 439 (Sept. 2000) (discussing corporate SEC filing requirements).

124. *Id.*



specific information about a fund's holdings, investors can be worse off than with a transparent description of the fund's holdings.<sup>125</sup>

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.<sup>126</sup> The ASRs, despite the limitations they place on *approaches* to fair-value determination, still give broad latitude with respect to the *values* boards assign.<sup>127</sup>

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*.<sup>128</sup> 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 challenge. 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

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125. Some funds may limit transparent disclosure for strategic reasons, perhaps to avoid providing information to competitors. To the extent that they do limit disclosure, specific valuations by the board may be more important to investors than transparent disclosure of descriptive information.

126. See *infra* Sections IV.A.2, IV.B.3 (discussing SEC proceedings of R. Marvin Mears and Parnassus Investments).

127. See ASR 113, *supra* note 7; ASR 118, *supra* note 8.

128. See *infra* Sections IV.A.2, IV.B.3 (discussing SEC proceedings of R. Marvin Mears and Parnassus Investments).

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.<sup>129</sup> 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.<sup>130</sup> Under the certification structure, investors can initiate legal action if they believe a fund has incorrectly valued its investments in fair-value assets.<sup>131</sup>

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 involving an open-end fund, the Parnassus Fund,<sup>132</sup> and the other involving a closed-end fund organized as a Business Development Company, Corporate Capital Resources, Inc.<sup>133</sup>

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129. See 1999 Letter, *supra* note 9; 2001 Letter, *supra* note 9.

130. See *infra* Sections IV.A.2, IV.B.3.

131. Jacob, *supra* note 123, at 444. "[A]ny information which is incorporated by reference from the annual report becomes part of the Form 10-K and is, therefore, subject to liability under Section 13." *Id.*

132. See *infra* Section IV.A.2.

133. See *infra* Section IV.B.3. 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.

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.<sup>134</sup> Liquidity enables the fund manager to respond to changes in demand for fund shares.<sup>135</sup> Nonetheless, within the bounds of providing for liquidity needs, open-end funds can devote a fraction of their resources to investments in illiquid assets.<sup>136</sup> 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.<sup>137</sup> This was the direction in which some mutual funds were headed in the late 1960s, before the ASRs were introduced.<sup>138</sup>

1. 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 ten to fifteen percent of fund value.<sup>139</sup> Even open-end funds that specifically target investments

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134. See TEWELES & BRADLEY, *supra* note 69, at 415.

135. *Id.*

136. See *infra* note 139 and accompanying text (outlining the SEC's liquidity requirements).

137. Vikram Nanda, M.P. Narayanan & Vincent A. Warther, *Liquidity, Investment Ability, and Mutual Fund Structure*, 57 J. FIN. ECON. 417, 417 (2000). They have developed 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. *Id.* They argue that open-end funds offer advantages over closed-end funds when investors are uncertain about manager quality. *Id.* They do not address bias in NAV measurement. *Id.* However front-end loads and exit fees also limit investors' abilities to arbitrage pricing biases. *Id.*

138. SEC Study, *supra* note 39; ASR 113, *supra* note 7, at 62,284.

139. 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 Interpretive Release Relating to the Investment Company Act of 1940 and Rules and Regulations Thereunder: Restricted Securities, 17 CFR pt. 271, December 31, 1970; Periodic Repurchases by Closed-End Management Investment Companies; Redemptions by Open-End

in small and early-stage companies have adopted the SEC's guidelines. The policy of Pioneer (formerly Pioneer Micro-Cap Fund) for example, limits investments in illiquid assets to not more than fifteen percent of net assets.<sup>140</sup> Similarly, Invesco Emerging Growth Fund I limited investment in restricted and illiquid securities to ten percent or less of total assets.<sup>141</sup> In a Statement of Additional Information ("SAI") for its Emerging Growth Fund, Small Company Value Fund, Small Company Growth Fund, and Post-Venture Capital Fund, Warburg Pincus states, "[e]ach of the Post-Venture Capital and Small Company Growth Funds may invest up to fifteen percent of its net assets (ten percent of total assets in the case of the Emerging Growth and Small Company Value Funds) in non-publicly traded and illiquid securities. . . ."<sup>142</sup> The SAI notes, "[m]utual 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."<sup>143</sup>

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 of open-end funds annually and reports the percentage held of "restricted/illiquid securities." In the most recent survey (2000)<sup>144</sup>, we reviewed the reported share of

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Management Investment Companies and Registered Separate Accounts at Periodic Intervals or With Extended Payment, Securities Act Release No. 33,6948, Exchange Act Release No. 34,30967, 57 Fed. Reg. 34,701 (Aug. 6, 1992).

140. Pioneer Small Cap Value Fund, Statement of Additional Information, p. 2, Sept. 6, 2001, *available at*

<http://www.sec.gov/Archives/edgar/data/1025187/000101696401500153/scv09060149c.txt>.

141. Invesco Emerging Growth Fund, Prospectus, p. 10, Sept. 11, 1995, *available at*

<http://www.sec.gov/Archives/edgar/data/870781/000087078195000011.txt>.

142. Warburg Pincus Emerging Growth Fund, Warburg Pincus Post-Venture Capital Fund, Warburg Pincus Small Company Growth Fund, Warburg Pincus Small Company Value Fund, State of Additional Information, p. 24, Feb. 16, 1999 (as revised Jan. 3, 2000), *available at*

<http://www.sec.gov/Archives/edgar/data/948207/000095013-00-000010-index.html>.

143. *Id.*

144. MORNINGSTAR, INC., MORNINGSTAR MUTUAL FUND 500 (Kevin King &

restricted or illiquid assets for funds that specialize in equities.<sup>145</sup> With minor exceptions involving small funds, the share of securities that are restricted or illiquid was reported as “trace” or 0-1%.<sup>146</sup> Thus, open-end funds, even those specializing in small-cap equities, now generally avoid restricted securities.

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.<sup>147</sup> Debt investments are not subject to the same valuation difficulties as equity, they are not required to be valued based on current-sale, and are more easily tradable with other institutions under Rule 144A.<sup>148</sup>

## 2. Case Study: In Matter of Parnassus Investments (1998)

Because open-end funds have withdrawn from ownership of fair-value assets, litigation is rare. One exception is the Parnassus Fund.<sup>149</sup> 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.<sup>150</sup> 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

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Jennifer Watts eds., 2001).

145. *Id.*

146. *Id.*

147. MORNINGSTAR, *supra* note 144.

148. 17 C.F.R. § 230.144A.

149. In the Matter of Parnassus Investments et al., Initial Decision Release No. 131, Administrative Proceeding, File no. 3-9317, 1998 SEC Lexis 1877 (September 3, 1998).

150. *Id.* at \*2.

share.<sup>151</sup> In March 1989, Margaux filed for bankruptcy under Chapter 11.<sup>152</sup> After the announcement, Margaux shares declined in value to \$.28, at which price Parnassus purchased 250,000 more registered shares.<sup>153</sup> 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.<sup>154</sup> The loan was convertible to 1.5 million shares of restricted Margaux stock.<sup>155</sup> At the time, year-end 1989, the Fund's total NAV was \$23.0 million, and the loan represented 0.4% of NAV.<sup>156</sup> Initially, Parnassus valued the investment at the note's face value of \$100,000.<sup>157</sup> In October 1989, when the conversion rights were approved by the bankruptcy court, Margaux's registered stock was trading for \$.44.<sup>158</sup> 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% of the Fund's year-end 1989 NAV).<sup>159</sup> In making the determination, the board gave no consideration to the fact that the shares to which the loan was convertible would be restricted.<sup>160</sup> The Fund carried the note at its conversion value until August 1990.<sup>161</sup> At that point, it added a ten percent premium to the note's value to reflect the convertibility feature.<sup>162</sup>

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).<sup>163</sup> The Fund's manager indicated that he

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

152. *Id.* at \*3.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.* (calculating the loan amount by dividing \$100,000 by \$23 million).

157. *Id.* at \*4.

158. *Id.* at \*3.

159. *Id.* at \*4.

160. *Id.*

161. *Id.*

162. *Id.*

163. In August 1990, Margaux was delisted from NASDAQ due to its negative net worth. After delisting, Margaux stock was quoted only in the Daily

did not believe the pink sheet price was a reliable measure of fair value.<sup>164</sup> The board elected to maintain the value at \$.344 based on its view of Margaux's future prospects.<sup>165</sup>

In February 1991, Margaux informed Parnassus that it was performing below expectations.<sup>166</sup> In March 1991, the board reviewed its valuation and determined not to adjust the value.<sup>167</sup> It continued to carry the loan at a conversion value of \$516,000 or 2.5% of Fund NAV.<sup>168</sup> 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.<sup>169</sup> In December 1991, after further under-performance by Margaux, but positive cash flows, the board retained its valuation.<sup>170</sup> By then, the Fund had grown significantly and its convertible debt position accounted for 1.6 percent of Fund NAV.<sup>171</sup> In July 1992, Margaux showed improving performance, but the Fund's board retained its prior valuation.<sup>172</sup> The board retained the same valuation in December 1992 and continued to grow, so the convertible debt position accounted for 0.9% of NAV.<sup>173</sup>

In January 1994, the Fund became aware that Margaux's key customer was having problems.<sup>174</sup> Based on that information, the board reduced its valuation of Margaux to \$.20 and eliminated the ten percent conversion premium on the note.<sup>175</sup> In July 1994, the Fund reduced its valuation to \$.15 based on continuing negative news.<sup>176</sup> In the fall of 1994, the Fund sold its holdings of Margaux

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Quotation Bureau's "pink sheets." *Id.* at \*5.

164. *Id.* at \*6.

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.* at \*7.

173. *Id.* (calculating the loan percentage of total assets by dividing the debt position by the funds reported NAV as of December 1992).

174. *Id.* at \*23.

175. *Id.*

176. *Id.*

for \$.27 per share.<sup>177</sup> On that basis, the original \$100,000 loan generated proceeds of \$180,000.<sup>178</sup>

a. The Litigation

The SEC's position was that the Fund had violated the Investment Company Act by not using the current-sale methodology reflected in ASRs 113 and 118.<sup>179</sup> The court found that the Parnassus board failed to act in good faith.<sup>180</sup> 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.<sup>181</sup>

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.<sup>182</sup> 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 fifty percent discount.<sup>183</sup> The court also rejected the board's argument for ascribing a conversion premium to the note.<sup>184</sup>

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.<sup>185</sup> 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 fifteen percent of Margaux shares.<sup>186</sup> The court also accepted the SEC position that the holdings should be discounted by an additional twenty-five percent due to market

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177. *Id.*

178. *Id.* at \*29.

179. *Id.* at \*30.

180. *Id.* at \*38.

181. *Id.* at \*47.

182. *Id.* at \*54.

183. *Id.* at \*45.

184. *Id.* at \*51.

185. *Id.* at \*48.

186. *Id.*



illiquidity.<sup>187</sup>

b. 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 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 law places the administrative law judge ("ALJ") in the position of making value determinations. The ALJ's valuations often were inconsistent with general market evidence.<sup>188</sup> For example, the ALJ concluded that there could be no control

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187. *Id.* at \*47.

188. For example, in a recent case involving a closed-end fund, the ALJ imposed a valuation approach that does not reflect modern financial economic theory: he valued options (warrants) at zero and valued restricted shares at cost. *See In the Matter of Carroll A. Wallace, CPA, Administrative Proceeding File No. 3-9862, Initial Decisions Release No. 178, 2000 SEC LEXIS (Dec. 18, 2000).*

premium because the Fund did not have a controlling interest. However, financial economics literature documents that a fifteen percent equity interest can attract a control premium. In conjunction with other shares, fifteen percent may be sufficient to determine control, and often is sufficient to guarantee board representation.

The ALJ also accepted the SEC's argument for a fifty percent illiquidity discount, despite absence of evidence justifying the discount.<sup>189</sup> 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.<sup>190</sup> 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.<sup>191</sup>

### 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.<sup>192</sup> The liquidity of fund assets is not directly 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.<sup>193</sup> Rather, they rely on whatever liquidity exists in the

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189. *Parnassus*, 1998 SEC Lexis, at \*57.

190. *Id.* at \*74.

191. 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 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. *Id.* at \*75.

192. See Haines, *supra* note 69, at 3 ("Since closed-end funds have their own assets . . .").

193. See *id.* at 3.

capital market for secondary transactions.<sup>194</sup>

1. Evidence that Closed-end Funds Avoid Restricted Shares

In contrast to open-end funds, the investment policies of closed-end funds are more varied.<sup>195</sup> For example, the Royce Funds annual report emphasizes the value of closed-end structure for investing in securities with limited liquidity.<sup>196</sup> Nonetheless, the fund limits itself primarily to investing in small capitalization registered shares.<sup>197</sup> As of year-end 2009, Royce reported that only 1.31% of its micro-cap assets lacked readily available market quotations and required fair value determinations.<sup>198</sup> In contrast, Equus II, Inc. is a closed-end fund classified as a Business Development Company.<sup>199</sup> 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.<sup>200</sup> Many of the fund's investments are in non-reporting companies.<sup>201</sup> Virtually all of its holdings are subject to fair value determination.<sup>202</sup> Equus II is a significant exception to the normal investment practices of closed-end funds. Among fifty-seven diversified equity closed-end funds identified in a 1999 *Wiesenberger Closed-End Weekly Review*, Equus II was the only

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194. *Id.*

195. For an example of two contrasting closed-end mutual fund policies, see Equus II, Inc., Form 10-K, Dec. 31, 2000, available at <http://www.sec.gov/Archives/edgar/data/878932/000089056601000204/0000890566-01-000204-0001.txt> [hereinafter Equus]; The Royce Funds: Royce Value Trust, Royce Micro-Cap Trust, Royce Focus Trust, Form N-30D, Dec. 31, 2000, available at

<http://www.sec.gov/Archives/edgar/data/912147/000100547701001826/0001005477-01-001826-0001.txt> [hereinafter Royce].

196. Royce, *supra* note 195.

197. *Id.*

198. *Id.*

199. Equus, *supra* note 195.

200. *Id.*

201. *Id.*

202. *Id.*

fund with a significant fraction of fair-value assets.<sup>203</sup>

## 2. Letter Stock Funds

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"<sup>204</sup> 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.<sup>205</sup>

As an example, one of the funds, the "Fund of Letters (the "Fund"),<sup>206</sup> established a policy in 1968 that enabled it to invest up to one hundred of total assets in restricted securities.<sup>207</sup> The Fund intended to invest at least eighty percent of its assets in restricted securities, with at least fifty percent of its assets in restricted shares with a public, unrestricted market and no more than twenty-five percent in restricted shares without any publicly traded securities.<sup>208</sup> The Fund's valuation policy did not conform to ASR guidelines: restricted stocks of public companies were valued based on the discount at purchase, other restricted shares were valued at cost.<sup>209</sup> 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.<sup>210</sup> During this same year, Wiesenberger highlighted concern about restricted stock

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203. Wiesenberger Closed-End Weekly Review, (Thomson Financial) (Jun 18, 1999) (available on file at the Journal of Corporate and Financial Law).

204. 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 *supra*, note 31 and accompanying text (providing a definition of letter stock).

205. Table 1, *infra* Appendix B.

206. *Id.*

207. WIESENBERGER INVESTMENT COMPANIES, MUTUAL FUNDS AND OTHER TYPES 403 (v. 1969).

208. *Id.*

209. *Id.*

210. *Id.*

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.<sup>211</sup>

Figure 1<sup>212</sup> 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 declined from the 1969 high of sixty-seven 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.<sup>213</sup>

No large closed-end fund has since pursued this investment approach. Those that do invest in fair-value assets generally organize as Business Development Companies ("BDC"s) and are too small to attract large investors and too small for the board's NAV determinations to create significant potential for litigation.<sup>214</sup> This is in sharp contrast to the venture capital market, which generated approximately \$50 billion in new capital commitments in

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211. *Id.*; see also Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 *et seq.* (2000); Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1 *et seq.*; Valerie Ford Jacob, *Understanding the Securities Laws 2000; Registration And Reporting Under The Securities Exchange Act Of 1934*, 1198 PLI/Corp 415, 439 (Sept. 2000) (discussing the securities registration requirements).

211. Figure 1, *infra* Appendix B.

213. 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*, 1974 U.S. Dist. LEXIS 8099 (S.D.N.Y. June 13, 1974).

214. 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.

1999.<sup>215</sup>

### 3. Case Study: In the Matter of R. Marvin Mears (1996)

The SEC's case against a director of Corporate Capital Resources, Inc.<sup>216</sup> ("CCRS") illustrates the risks of closed-end fund investment in restricted shares. CCRS was formed in 1969 and operated as a BDC.<sup>217</sup> It invested in shares of non-public companies and restricted shares of public companies, including high-risk companies that faced significant risk of failure.<sup>218</sup> CCRS acquired its shares in privately-negotiated transactions.<sup>219</sup> 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."<sup>220</sup> This approach sometimes resulted in reporting an immediate gain, compared to the price CCRS paid for the shares.<sup>221</sup> 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.<sup>222</sup> The "Investee Company Valuation Review" sheet for each company, showed the pink sheet quote and value calculation.<sup>223</sup> With one exception, the Committee approved the valuations.<sup>224</sup>

#### a. The Litigation

In this litigation, the SEC charged that CCRS had materially overstated the value of its holdings.<sup>225</sup> As a member of the

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215. *Venture Capital - Money to Burn*, *supra* note 15, at 71. "In 1999 investors pumped a record \$56 billion into American venture capital funds." *Id.*

216. In the Matter of R. Marvin Mears, U.S. Securities and Exchange Commission, Administrative Proceeding, Release No. 21783, 1996 SEC Lexis 523, (Sept. 3, 1998). The case was settled before reaching a verdict.

217. *Id.* at \*2.

218. *Id.* at \*3.

219. *Id.*

220. *Id.* at \*3.

221. *Id.*

222. *Id.* at \*4.

223. *Id.*

224. *Id.* at \*3.

225. *Id.* at \*2.

Valuation Committee, Marvin Mears was one of the individuals responsible for approving the valuations.<sup>226</sup>

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."<sup>227</sup> 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."<sup>228</sup> The method wholly ignored the underlying financial condition and business prospects of the portfolio companies.<sup>229</sup> Most were unprofitable and/or insolvent."<sup>230</sup> Third, the Valuation Committee did not follow appropriate process because the "[c]ommittee did not hold regular meetings, or conduct independent research, did not review any documents such as contracts, pricing information, or financial statements."<sup>231</sup> The SEC argued that: "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 securities which are held by CCRS and the ability of CCRS to dispose of large blocks of securities in an orderly manner."<sup>232</sup>

#### b. 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.<sup>233</sup> In its view, such quotes are not firm offers to buy and CCRS's holdings might be too substantial to

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226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.* at \*4.

232. *Id.* at \*5.

233. *Id.*

liquidate easily.<sup>234</sup> 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.<sup>235</sup> 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.<sup>235</sup> 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.<sup>237</sup> 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.<sup>238</sup> For example, the SEC is critical of the Committee for not verifying security ownership or market quotations.<sup>239</sup> In addition, the SEC implies that, unless the Valuation Committee regularly challenges the valuation conclusions of fund managers, it is not performing its function.<sup>240</sup>

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.<sup>241</sup> 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

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234. *Id.*

235. *Id.*

236. *Id.* Though in the Parnassus case, it linked its valuation directly to pink sheet quotations for Margaux. *Parnassus*, 1998 SEC Lexis, at \*15.

237. *Mears*, 1996 SEC LEXIS 523.

238. *Id.*

239. *Id.*

240. *Id.*

241. *Id.*



the valuation of shares of non-public companies.<sup>242</sup>

## 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 under-diversification. In 1999 and early 2000, many venture capital limited partnership funds earned high returns on their investments in Internet companies.<sup>243</sup> Investors in the venture capital funds (primarily institutions other than mutual funds) often realized the returns through IPOs of the portfolio companies.<sup>244</sup> 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.<sup>245</sup> 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

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242. *Id.*

243. *Venture Capital - Money to Burn*, *supra* note 15, at 71. “[D]uring 1999 alone venture-capital funds generated an internal rate of return to investors of a whopping 150% . . .” *Id.*

244. *Id.*

245. Examples include options, futures, and other derivative instruments, a wide array of mutual funds, and real estate investment trusts.

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.<sup>245</sup> 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, "[s]ome 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."<sup>247</sup> 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.<sup>248</sup> 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.<sup>249</sup>

The Commission recognized that its prior restrictions on open-end fund activity should increase investor reliance on closed-end funds.<sup>250</sup> However, noting that closed-end 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.<sup>251</sup> The 1992 rules provide that closed-end funds can respond to market undervaluation by tendering to repurchase their own outstanding shares at NAV.<sup>252</sup> The rationale for the change was to enable managers to reduce or eliminate

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246. 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, Securities Act Release No. 33-6948, Exchange Act Release No. 34,-30967, 57 Fed. Reg. 34,701 (Aug. 6, 1992).

247. *Id.*

248. *Id.* at 19.

249. *Id.* at 7.

250. *Id.* at 8.

251. *Id.*

252. *Id.*

closed-end fund discounts by buying fund shares at NAV.<sup>253</sup> 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. . .”<sup>254</sup>

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,”<sup>255</sup> and again in 1996, under the “Securities Market Improvement Act.”<sup>256</sup> 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.<sup>257</sup>

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.<sup>258</sup> Nor has closed-end fund investment in illiquid assets increased.

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

253. *Id.*

254. *Id.* at 2.

255. Small Business Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

256. Securities Market Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

257. Final Report of the SEC Government-Business Forum on Small Business Capital Formation, U.S. Securities and Exchange Commission Division of Corporate Finance, March 1996, *available at* <http://www.sec.gov/info/smallbus/finrep14.txt>.

258. MORNINGSTAR, *supra* note 144.

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. Thus, permitting closed-end funds to tender at NAV is unlikely to motivate investment in fair-value assets.

C. Market-Based Innovations to Appeal 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.<sup>259</sup> 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.<sup>260</sup> Incorporated in 1986, CMGI's business model is to add value to its portfolio companies by providing centralized services and by achieving synergies among the companies.<sup>261</sup> 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."<sup>262</sup> Thus, it draws a distinction between investments where it expects to

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259. CMGI, Inc., Form S-3 Registration Statement, filed September 11, 2000, available at <http://www.sec.gov/Archives/edgar/data/914712/000095017200001579/0000950172-00-001579.txt>.

260. CMGI, Inc., *supra* note 259, at 10.

261. *Id.*

262. *Id.*

continue involvement and those it seeks to harvest.<sup>263</sup>

CMGI operates much like a closed-end fund organized as a business development company.<sup>264</sup> 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.<sup>265</sup>

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....<sup>266</sup>

In contrast to mutual funds, CMGI accounts for its on-going investments in portfolio companies on a cost or consolidation

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263. *Id.*  
264. *Id.*  
265. *Id.*  
266. *Id.*

basis.<sup>267</sup> 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.<sup>268</sup> It determines fair value "based on quoted market prices, net of a market value discount to reflect any remaining restrictions on transferability."<sup>269</sup> Thus, it bases valuation on an estimate of going-concern value and not on current sale.<sup>270</sup> 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.<sup>271</sup>

The Company's preliminary registration statement includes a discussion of its valuation principles.<sup>272</sup> Generally, its valuations are tied to historical cost.<sup>273</sup> In some cases, for non-public companies, idealab! adjusts carrying value based on third-party transactions pertaining to portfolio companies.<sup>274</sup> For public companies, when restrictions on sale are for less than one year, idealab! relates

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267. *Id.*

268. *Id.* at 8.

269. *Id.* at 10.

270. *Id.*

271. Idealab! Preliminary Registration Statement, Form S-1, dated April 20, 2000, available at

<http://www.sec.gov/Archives/edgar/data/1045647/0001092388-00000145.txt>. As of this writing, the company's registration was postponed due to a downturn in electronic commerce firm market values.

272. *Id.*

273. *Id.*

274. *Id.*

valuation to the market price of unrestricted shares.<sup>275</sup> As with CMGI, its statements are not based on the current-sale principle.<sup>276</sup>

*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.<sup>277</sup> 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.<sup>278</sup> Investors necessarily based their decisions 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.

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275. *Id.*

276. 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, dated March 23, 2000, available at <http://www.sec.gov/Archives/edgar/data/50863/0001012870-00-001562.txt>.

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.

277. See ASR 113, *supra* note 7; ASR 118, *supra* note 8.

278. *Id.*

Practices in use by public holding companies suggest a two-pronged solution to mutual fund valuation concerns. First, investors would be better served by greater reliance on transparency and less on certification. Second, investors would be better served by allowing fund boards more latitude in their valuation policies.

### 1. Transparency v. Certification

As documented above, 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.<sup>279</sup> 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.<sup>280</sup> 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.<sup>281</sup> Current technology would enable funds to report changes in holdings daily

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279. 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, *Basic, Inc. v. Levinson*, 485 U.S. 224, 247 (1988). 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. See Julia K. Cronin et al., 33 *Am. Crim. L. Rev.* 1277, 1322-1326 (2001).

280. See Haines, *supra* note 69. "The value of a closed-end funds NAV is typically determined on either a daily or weekly basis." *Id.*

281. TEWELES & BRADLEY, *supra* note 69, at 413-417.



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 investors need to make their own assessments 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 investors with the information they need to make their own assessments.

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 the 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.<sup>282</sup> 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.<sup>283</sup> As recognized in the 1995 Private Securities Litigation Reform Act,<sup>284</sup> 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

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282. See EDGAR Search Facility, at <http://www.sec.gov/cgi-bin/srch-edgar>. Examples of CMGI's subsidiaries include Adforce Inc., Engage Technologies, Flycast Communications, Inc., and uBid, Inc.

283. To enable 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.

284. The 1995 Private Securities Litigation Reform Act, Pub. L. No. 104 P.L. 67, 109 Stat. 737 (1995).

today by the risks of fair-value certification and the current-sale principle, would not respond similarly to the market's demand for information.

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.<sup>285</sup> In such cases, the court is in the position of arbiter of fair value, a responsibility for which it often is not qualified.

## 2. 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

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285. See the discussion of *Mears*, *supra* at Section B-3; *Parnassus*, *supra* at Section A-2.

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.<sup>286</sup> 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.<sup>287</sup> 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.<sup>288</sup>

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

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286. TEWELES & BRADLEY, *supra* note 69, at 413.

287. 15 U.S.C. § 80-1 *et seq.* (2000).

288. The 1995 Private Securities Litigation Reform Act protects managers of public corporations from liability for non-fraudulent forward-looking statements. See The 1995 Private Securities Litigation Reform Act, Pub. L. No. 104 P.L. 67, 109 Stat. 737 (1995).

share holdings based on the market values of unrestricted shares, and allowing the market to make its own determination of value.

#### SUMMARY AND CONCLUSIONS

In an unconstrained capital market, financial economic theory implies that well-diversified individual investor portfolios would include venture capital, private equity, or restricted shares of public companies. Inability of individual investors to invest in illiquid assets results in underdiversification of individual investor portfolios and may reduce expected investment returns. For example, in the recent tech-stock boom and bust episode, individual investors were harmed because they held technology stocks during the decline but were unable to benefit from the boom by investing early on in venture capital funds.

In principle, the easiest way to for individual investors to invest in venture capital, private equity, or restricted shares of public companies would be by investing in mutual funds that were partially diversified into such assets. Closed-end funds, in particular could invest in illiquid assets, as investors in closed-end funds do not look to the fund to provide liquidity for their investments. Even open-end funds are legally permitted to invest small fractions of their holdings in illiquid assets. Despite the apparent opportunity to create value for investors, mutual funds generally do not invest in illiquid assets. Consequently, individuals who wish to own such securities are unable to do so through diversified mutual funds. They are either foreclosed from those opportunities or forced to seek alternative means of investing.

In this paper, we present evidence that the current lack of mutual fund involvement in the markets for illiquid equity is a direct response to SEC policies and regulations. During the late 1960s mutual fund investment in illiquid assets, restricted stock, in particular, was on the rise. After 1970, however, funds began to retreat from illiquid investments and are now virtually out of those markets.

Our evidence suggests 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. In

1969 and 1970, through two releases, the SEC interpreted fair value to mean value in current sale and imposed its own judgments regarding possible relations between the values of restricted shares and otherwise-identical freely traded shares. Our analysis of the markets for illiquid assets implies that adherence to the SEC interpretive releases would result in systematic undervaluation of illiquid assets and would cause funds to understate their net asset values.

Furthermore, 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. By depriving closed-end funds of the opportunity to base valuations of restricted shares on adjustments to the values of freely traded shares, the interpretive releases elevate the liability exposure of mutual fund directors. We consider whether "transparency" of holdings, as an alternative 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 the SEC's 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. We examine several recent financial innovations that are designed to open illiquid asset investment to individual investors and to circumvent regulation under the Investment Company Act. We conclude 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.

APPENDIX A: TABLE 1

Table 1 shows total NAV in millions and the percent of NAV invested in restricted securities and venture capital (Pat. II) for closed-end funds that are designated as "Letter Stock Funds" in Wiesenthaler Investment Companies (WIC) for the years ending 1969-1979<sup>1</sup>

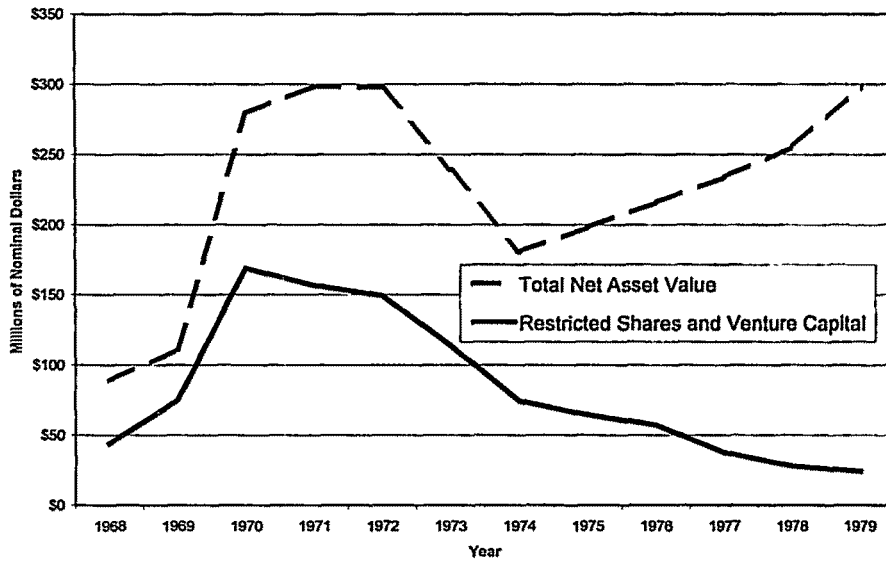
Fund	Year Formed	Investment Type	Year											
			1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Dishold Tech. Venture Fund <sup>2</sup>	1968	NAV	28.4	26.2	16.2	14.9	16.3	12.9	8.9	11.0	11.6	14.7	18.1	21.0
		Pat. III <sup>3</sup>	16.0%	54.5%	78.6%	78.6%	82.0%	87.2%	73.6%	74.9%	41.9%	32.6%	23.1%	14.5%
Fund of Letters <sup>4</sup>	1968	NAV	31.1	34.3	24.0	22.2	27.5	18.6	17.3	17.9	23.9	32.5	44.8	52.9
		Pat. III <sup>3</sup>	55.0%	85.0%	62.1%	58.5%	25.6%	17.7%	15.1%	27.6%	11.6%	9.6%	17.1%	11.1%
Investure Capital Corporation <sup>5</sup>	1969	NAV	19.1	10.5	11.4	7.9	2.2							
		Pat. III <sup>3</sup>	25.0%	25.7%	31.4%	23.9%	22.8%							
Pine Capital Corporation <sup>6</sup>	1969	NAV	15.0	9.2	11.0	9.0	5.3	4.6	8.9	8.0	11.5	9.6	12.5	
		Pat. III <sup>3</sup>	16.9%	38.4%	44.2%	34.1%	31.4%	23.9%	19.6%	14.6%	4.6%	4.6%	4.6%	
SMC Investment Corporation <sup>7</sup>	1968	NAV	192.8	22.5	21.0	16.3	13.3	13.3	11.3	12.4	15.8	13.5	13.6	
		Pat. III <sup>3</sup>	58.8%	47.4%	42.0%	47.2%	43.8%	23.0%	23.9%	14.6%	7.0%	14.6%		
Vista Line Dev. Capital Corp. <sup>8</sup>	1968	NAV	27.6	35.8	27.2	27.5	23.4	14.5	13.6	13.3	9.8	9.7	13.8	
		Pat. III <sup>3</sup>	75.0%	72.0%	81.1%	82.0%	83.1%	78.9%	78.9%	65.5%	62.1%	43.8%	35.0%	22.3%
Total Total		NAV	89.1	111.3	239.5	233.6	177.6	212.5	163.9	152.2	216.2	234.3	233.7	233.4
		NAV	44.2	74.7	162.1	157.0	142.5	113.9	74.2	64.2	87.3	87.5	27.7	24.1
		Pat. III <sup>3</sup>	49.6%	67.1%	69.8%	52.6%	52.2%	47.6%	41.6%	32.4%	23.5%	19.0%	12.6%	8.1%

<sup>1</sup> Included Glenwood Capital Corporation in 1977  
<sup>2</sup> Included New America Fund in 1971  
<sup>3</sup> Included Emerging Securities Fund in 1974  
<sup>4</sup> Included Highland Capital Corporation 1972  
<sup>5</sup> Included Source Capital 1973

<sup>1</sup> WIESENBERGER INVESTMENT COMPANIES, MUTUAL FUNDS AND OTHER TYPES (v. 1999) - Bolded figures are not available. Percentages are assumed to be the same as in the prior year.

## APPENDIX B: FIGURE 1

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



Source: Table 1, *supra* Appendix A (providing source data for Figure 1).