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File Reference: Proposed FSP FAS 157-e



LETTER OF COMMENT NO. 26

On behalf of MFS Investment Management ("MFS"), we are taking the opportunity to comment on FSP FAS 157-e (the "Proposal") as currently drafted. Our comments relate to the Proposal's application to investment companies registered with the Securities & Exchange Commission ("SEC") under the Investment Company Act of 1940 ("1940 Act") as issuers of financial statements and as entities required to value securities on a daily basis to effect shareholder transactions.

MFS is a global asset management firm providing investment management services to clients including more than 70 registered open-end investment companies (commonly referred to as mutual funds) and several closed-end investment companies. MFS and its predecessor organizations have been registered as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") since 1969. MFS is a majority owned subsidiary of Sun Life of Canada (U.S.) Financial Services Holdings, Inc., which in turn is an indirect majority owned subsidiary of Sun Life Financial, Inc. (a diversified financial services organization) ("Sun Life"). MFS has been a subsidiary of Sun Life since 1982. As of December 31, 2008, MFS was managing approximately \$134 billion in assets.

MFS generally supports the comment letter submitted by the Investment Company Institute. Specifically, we are concerned that the application of the Proposal to mutual funds could result in different valuations for portfolio securities being used depending upon whether the valuation is for purposes of determining a fund's net asset value or for financial reporting purposes. We also are concerned that the criteria for assessing inactive markets and distressed sales prescribed in the Proposal overemphasizes the existence of an inactive market, e.g. illiquidity, in determining when to stop relying upon market quotations. An inactive market alone, without taking into account other market indicators of unreliability, should not dictate when an entity should cease to rely upon a market quotation. Finally, if the changes to the Proposal recommended by MFS are not adopted, MFS requests that the effective time for the Proposal as applied to mutual funds be delayed.

A registered open-end investment company ("Fund") generally must sell and redeem its shares at a price that is based on the current net asset value ("NAV") of the shares that is next determined after receipt of an order for purchase or redemption. The term "value" is defined as follows:

(i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors.2

<sup>&</sup>lt;sup>1</sup> Rule 22c-1 under the Investment Company Act of 1940 ("1940 Act").

The SEC requires a Fund to calculate the current net asset value of its shares in accordance with the requirements set forth in Rule 2a-4 under the 1940 Act. That rule states in part that:

Portfolio securities with respect to which market 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>3</sup>

In determining whether market quotations for a security are "readily available," Funds rely on guidance that the SEC and its staff have provided over the years. In Accounting Series Release ("ASR") 118, the SEC stated that when a portfolio security is traded infrequently or thinly or if the quotations appear to be questionable, a Fund should consider whether market prices are readily available and, if it concludes that they are not, the security should be valued at its fair value as determined in good faith by the board of directors, in accordance with Section 2(a)(41) and Rule 2a-4 (in practice, the SEC has permitted Fund boards to adopt procedures pursuant to which Fund personnel make fair value determinations, subject to the oversight of the relevant Fund board).<sup>4</sup>

The SEC explained that in determining the "fair value" of a security, Fund boards must "satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered . . . [and] determine the method of arriving at the fair value of each such security. . . . The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security in the company's portfolio."

The SEC has not enunciated a single standard for determining fair value in good faith, recognizing that "fair value depends upon the circumstances of each individual case." However, ASR 118 reflects the general principle that the current "fair value" of a security is the amount which its owner might reasonably expect to receive for it upon its current sale. The SEC identified in ASR 118 several methods for determining the fair value of a security that would be acceptable and consistent with this general principle, including basing fair value on a multiple of earnings, or at a discount from the market value of a similar freely traded security, or yield to maturity with respect to debt issues, or a combination of these and other methods. The SEC recommended that Fund boards consider such general factors as:

- 1) the fundamental analytical data relating to the investment.
- 2) the nature and duration of restrictions on disposition of the securities, and
- 3) an evaluation of the forces which influence the market in which these securities are purchased and sold.

<sup>&</sup>lt;sup>2</sup> Section 2(a) (41) (B) of the 1940 Act.

<sup>&</sup>lt;sup>3</sup> Rule 2a-4(a)(1) under the 1940 Act.

<sup>&</sup>lt;sup>4</sup> Accounting Series Release No. 118, Investment Company Act Release No. 6295 (Dec. 23, 1970). Another release, Accounting Series Release No. 113, Investment Company Act Release No. 5847 (Oct. 21, 1969), discusses the determination of fair value with respect to restricted securities held by a Fund. In 1999, while noting that ASRs 113 and 118 were intended to provide only illustrative guidance on certain valuation issues, the SEC staff stated that it believed that ASRs 113 and 118 continued to represent the SEC's views. See Investment Company Institute, SEC No-Action Letter (avail. Dec. 8, 1999).

<sup>&</sup>lt;sup>5</sup> ASR 118, *supra.* 

<sup>6</sup> Id

The SEC also recommended that Fund boards consider such specific factors as: the 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 companies, and other relevant matters. The SEC said that these factors are illustrative, and that directors should take into consideration all indications of value available and deemed relevant in determining the "fair value" of the security.

The SEC's approach requires the application of judgment as to when a security should be valued at other than a market quotation even if the market for that security is inactive. Therefore the requirement to use other than a market quotation when one determines there is an inactive market as indicated in the Proposal would either: (a) run afoul of the SEC guidance set forth above; or (b) require Funds to use different valuations depending upon whether the valuation is for the purpose of computing the price at which a Fund must purchase or sell its securities or is for the purpose of preparing the Fund's financial statements. Furthermore the need to obtain multiple bids and other evidence to rebut the presumption in the Proposal would effectively eliminate the ability to use a market quotation for certain types of securities.

MFS believes that the valuation guidance within the Investment Company Act of 1940 has served the investment company industry well, and adequate guidance already exists with respect to the valuation of securities when reliable market quotations are not readily available. We believe that the current SEC requirements which require judgment and caution before determining whether a market quotation is not reliable adequately address the treatment of inactive markets and distressed transactions from a valuation standpoint, and, consequently, any changes to FAS 157 should be consistent with this fair value approach. MFS believes that the current version of FAS 157 allows for this consistency and therefore few if any changes to FAS 157 are necessary to accomplish the desired result.

However, if the FASB decides further guidance is necessary, MFS has two recommendations that we believe will ensure consistency with the '40 Act approach to valuation, enhance the practicality of the guidance and mitigate the impact of several issues the Proposal presents:

- 1. We recommend changing the wording in amended Paragraph 29A which indicates that the entity "must" use a valuation technique other than the quoted price for a "distressed transaction to "may" use. The ability to use a different technique should be an option, not a requirement. Using this approach, entities will not be forced to ignore potentially valid inputs to the pricing process. In other words a market could be inactive, a transaction could be distressed but taking into account all of the other factors the SEC has said that a mutual fund should consider the quotation could still be fair value with no adjustment necessary.
- 2. We suggest eliminating the presumption of a distressed transaction in Step 2 of amended Paragraph 29A in the event a determination of an inactive market is made. We recommend that the proposal presume that transactions are not distressed and require entities electing to default to alternative valuation techniques to gather evidence to support their opinion that other than a market quotation is required.

If the Proposal is not adjusted for consistency with the '40 Act, MFS believes that additional time would be required to establish and implement the new methodology and therefore the effective date should be extended, insofar as it would apply to Funds.

MFS appreciates the opportunity to offer comments to the Proposal. If you have any questions about our comments please feel free to call me at (617) 954 5637.

Sincerely.

John Corcoran

Senior Vice President and Fund Treasurer

MFS Investment Management

CC: Maria Dwyer, Executive Vice President, MFS Investment Management David DiLorenzo, Assistant Treasurer, MFS Investment Management