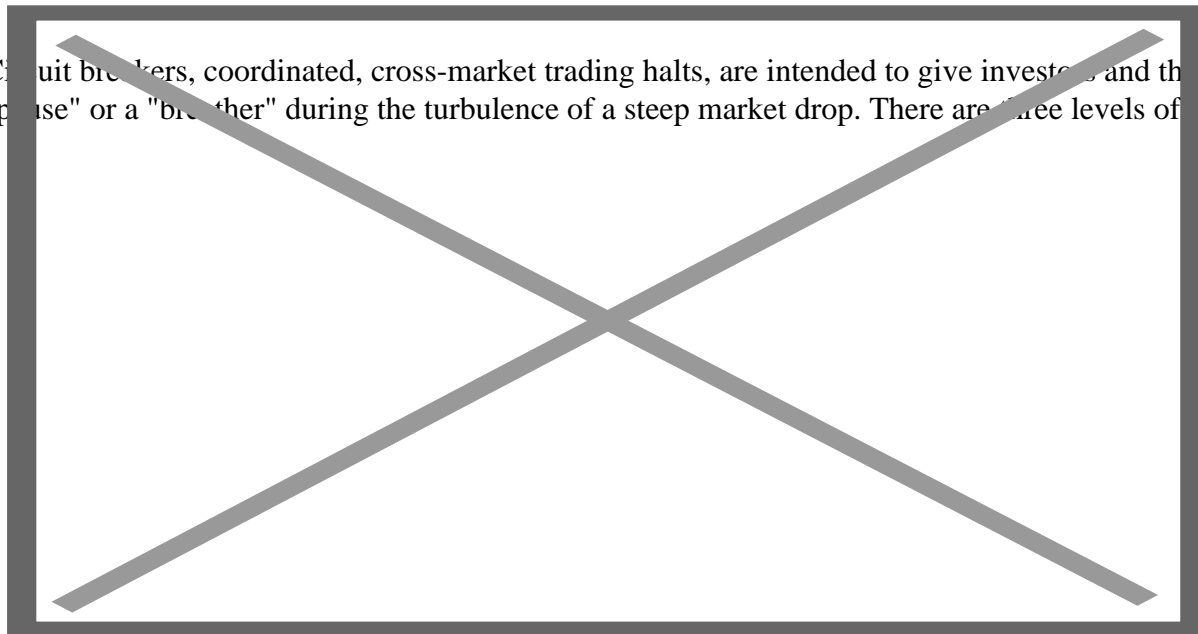


Navigating Mutual Funds in Rough Markets—Preparing for an Early Close

On two separate days last week and again this morning, markets hit critical circuit breaker levels triggering U.S. exchanges to halt trading. Such large market declines remind us of the prospect of an early close if the S&P 500 falls more than 20% from the previous day's close. If such an event occurs, [open-end investment companies](#) ("mutual funds") will need to either (1) calculate their net asset values ("NAVs") at the time of the early close or (2) find alternative pricing sources for calculating their NAVs as of 4:00 pm (ET). The options available will depend in part on the mutual fund's prospectus disclosure.

Circuit Breakers

Circuit breakers, coordinated, cross-market trading halts, are intended to give investors and the markets a "pause" or a "breather" during the turbulence of a steep market drop. There are three levels of circuit breakers:



Circuit

breakers do not apply to trading outside registered exchanges, so many bonds and over-the-counter derivatives may continue to be traded.

Valuation Basics

[Rule 22c-1](#) requires a mutual fund to purchase and redeem its shares "at a price based on the current [NAV] of such [shares] which is next computed after receipt of" a trade order. Rule 22c-1 requires the fund's board of directors to set the time at which the net asset value is computed and Item 11(a) of [Form N-1A](#) requires the fund's prospectus to include a "statement as to when calculations of net asset value are made."

What Funds Disclose

Except for money market funds, we have not seen a fund that did not specify the close of the NYSE as the time at which it calculates its NAV. We did a quick survey and found a variety of statements concerning market disruptions. Some funds:

- Reserve the right to ignore the "unscheduled close" and calculate their NAVs at the normal time, i.e., 4 o'clock;
- State that they will calculate their NAVs at the close of an alternative exchange as determined by the adviser; while many funds
- State they "generally" calculate their NAVs at the close of "regular" trading on the NYSE, without mentioning any exceptions.

How to Prepare if U.S. Exchanges Close Early

A fund's disclosed policies will determine its options for responding to an early close. We wonder if any funds that reserve the right to price at 4 o'clock notwithstanding a trading halt will exercise this option. This would require the fund to fair value its entire portfolio, but would allow orders to be processed without disruption. Disclosure that allows the NAV to be calculated at the close of an alternative exchange would require the adviser to designate a non-U.S. exchange, as the circuit breaker will be "market wide" in the U.S. This would also require the fair valuation of the funds' portfolios. On the other hand, if a fund's disclosure does not address the possibility of an early close, it might be advisable to treat the time of the halt as the time for calculating its NAV. This requires a fund holding investments traded on U.S. exchanges to confirm that its pricing administrator can obtain feeds for the last traded prices of its portfolio prior to the halt. Furthermore, to comply with Rule 22c 1 in this circumstance, the NAV should apply only to orders received by the fund and its intermediaries before the trading halt. Funds should review their contingency plans for such a disruption in order processing. Most mutual fund families have uniform disclosure regarding the calculation of their NAVs, so it may make sense to default to an early calculation time for all types of funds. While a U.S. trading halt would not affect mutual funds with portfolios traded outside the U.S., the NAVs of these funds are normally subject to fair valuation adjustments reflecting material changes in U.S. equity indices. These adjustments are based on U.S. equity trading and would only be valid as of the time of the trading halt. Assuming that fair valuation adjustments will still be provided in the event of an unscheduled close, these funds should also calculate their NAVs as of this time. The situation may be different for funds with non-exchange traded portfolios, such as bond funds. Pricing services typically provide feeds for these securities as of specific times (such as 3 and 4 p.m., ET) that may not correspond to the trading halt. Unless an interim price feed is available, it may not be possible to calculate the funds' NAVs at an earlier time. In this circumstance, there may not be any practical alternative to calculating the NAV as of the earliest time a feed is available, notwithstanding the fund's disclosure.

Conclusion

This may be an opportune time to review your funds' contingency plans for an unscheduled close of U.S. exchanges and to refresh their disclosures if appropriate.

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