

What Constitutes a “Significant Event”?

Peter Ciampi, Interactive Data Pricing and Reference Data, Inc.
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In an April 30, 2001 letter to Craig S. Tyle, General Counsel of the Investment Company Institute, the staff of the Securities and Exchange Commission (“SEC”) clarified a mutual fund’s obligation to use fair value pricing when market quotations are not readily available. The SEC staff stated that:

*If the fund determines that a significant event has occurred since the closing of the foreign exchange or market, but before the fund’s NAV calculation, then the closing price for that security would not be considered a “readily available” market quotation and the fund **must** value the security pursuant to a fair value pricing methodology. (Emphasis added.)*

Based on this statement, the critical inquiry is what constitutes a “significant event?” The SEC staff letter defines a significant event as “an event that will affect the value of a portfolio security” but does not explain how that determination is to be made. The staff did provide some examples. It observed that “significant fluctuations in domestic or foreign markets may constitute a significant event.” The letter further noted that significant events may also stem from occurrences that are not directly tied to the securities markets, such as natural disasters, armed conflicts, and significant governmental actions.

In White Paper #4¹, we suggested that significant fluctuations in markets constitute the overwhelming majority of significant events. This hypothesis, which is gaining acceptance, leads to additional questions, including: (1) How should market fluctuations be measured? and (2) How significant must a market fluctuation be to constitute a “significant event”? The SEC has as yet provided no guidance for answering these inquiries.

One way to identify and measure market fluctuations is to track changes in relevant market indices. The SEC letter mentioned that:

Some funds have established milestones or trigger points which also may signal that significant events have occurred since the close of the foreign exchange or market on which their portfolio securities trade, such as a certain percentage rise or fall in the value of a basket of foreign securities that trade on another market, or a certain percentage change in a foreign futures index.

Ideally, the index that a fund selects would be one which provides up-to-date information at the close of all relevant foreign markets. The S&P 500 futures index might be a good choice because it is traded virtually twenty-four hours a day in substantial volume. The index should also be relevant to the fund’s holdings. Thus, for a fund exclusively holding Japanese equities, the Nikkei futures index might be the most sensible and efficient choice. Fluctuations in an index could be measured from 3:00 a.m. to 4:00 p.m. Eastern Time (“ET”) for funds exclusively holding Asian equity securities, from 11:30 a.m. to 4:00 p.m. ET for funds exclusively holding European equity securities, or at other times for mixed portfolios, depending on the capitalization of the securities in each region.

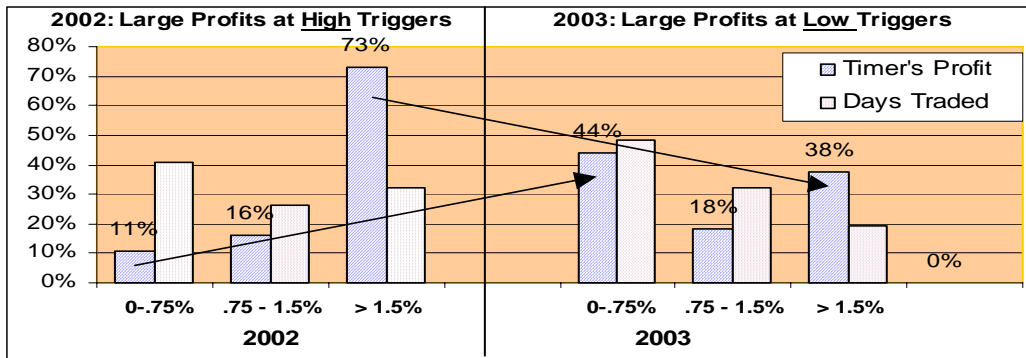
¹ *Pinpointing a “Significant Event”*; *Volatility Events Far Exceed Natural Disasters and Government Actions* (January 2002)

WHITE PAPER #7 (CONTINUED)

In White Paper #4, we suggested that a 0.75% change in the relevant market may constitute a significant event and thereby require the use of fair value pricing. Indeed, our research supports the conclusion that a significant event may occur at market fluctuations of less than 0.75%. In 2002, a non-trivial percentage of the arbitrage opportunity was evident on days with market fluctuations of less than 0.75%. Likewise, in 2003 (January-August annualized), there is more arbitrage opportunity on days with market fluctuations of less than 0.75% than on days with market fluctuations of greater than 1.5%.

To measure arbitrage opportunity at various levels, Interactive Data Pricing and Reference Data analyzed the effects on a hypothetical portfolio of this simple strategy: buy when the S&P 500 futures index rises by a certain percentage, or “trigger,” between 3:00 a.m. and 4:00 p.m. ET, and sell when the S&P 500 futures index falls by the same trigger. Interactive Data Pricing and Reference Data measured the excess profit realized by utilizing this strategy over a buy and hold strategy with 50% invested in the hypothetical portfolio and 50% invested in cash. We built our hypothetical portfolio based on the reported holdings of five large public funds owning both European and Asian equities. The following table shows the percentage of excess profits (excess profits were 65% and 41% in 2002 and 2003, respectively) and days traded in 2002 and 2003 based on the following ranges of triggers: 0 to 0.75%, 0.75% to 1.5%, and over 1.5%.

- In 2002 (the most volatile year since the depression year of 1938), most of the profits (73%) occurred at triggers greater than 1.5%. However, even in this volatile year, 11% of the profits were achieved at triggers less than 0.75%.
- By contrast, during 2003 (January-August annualized), only 38% of the profits occurred at triggers greater than 1.5% and 44% of the profits were achieved at triggers less than 0.75%.



This demonstrates that, even in less volatile years, to use a 0.75% (or greater) trigger for fair value pricing leaves considerable room for market timers. Greater precision may therefore be necessary.

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