MONEY & INVESTING

No Trading On Monday
U.S. markets close for Washington's Birthday, or Presidents Day. Regular trading resumes Tuesday.

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Mutual Funds' Muni-Debt Prices Are Questioned

The Securities and Exchange Commission is investigating whether some mutual funds have overstated the value of risky municipal bonds that are thinly traded, according to people familiar with the matter.

By Jean Eaglesham, Michael Corkery And Carrick Mollenkamp

The SEC probe, which is part of the agency's broader effort to investigate possible abuses in the municipal-bond market, comes at a time of concern about financial stresses on municipal borrowers.

The agency's concern is that investors in high-yield muni-bond mutual funds could be misled about the true value of their investment, according to people familiar with the matter.

These people cite the weakened muni market of the past few months. Fund managers have had to sell high-quality liquid assets in their portfolio to come up with cash as investors have withdrawn money from muni funds at an unprecedented rate.

In high-yield funds, which invest in "junk"-rated bonds, that selling can leave these bonds representing a higher proportion of the remaining assets. That change increases the odds that mismarking of these less-liquid assets overstates a fund's value, masking losses.

From mid-November through last week, muni-bond mutual funds have suffered net outflows of about $24.7 billion, according to Thomson Reuters unit Lipper FMI.

A spokesman for the SEC declined to comment.

Valuation problems don't necessarily signal bad intentions. Many municipal junk bonds are held by only a few of the approximately three dozen mutual funds that specialize in such risky bonds.

Many junk muni-bonds are thinly traded, making it potentially difficult to identify the current value of the bonds, some analysts say.

"There just aren't that many investors transacting in them

Got Liquidity?

The high yield municipal-bond market tends to be less liquid than the high yield corporate debt market, analysts say.

	Market value (billions)	Number of issues	Average issue size (millions)
Barclays Capital U.S. High Yield Index*	$970.7	1,873	$518.2
Barclays Cap Municipal High Yield Index*	$53.9	3,174	$16.9

*As of Feb. 16, 2011

Source: Barclays Capital

SEC Investigates How Funds Value Muni Debt

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thus compromising the integrity of the evaluation," says Thomas Doe, chief executive of research firm Municipal Market Advisors in Concord, Mass.

Valuation questions about illiquid securities have long been a concern among market participants and regulators, including during the subprime-mortgage loan crisis.

In an SEC case against broker-dealer Morgan Keegan & Co., regulators allege that a subprime fund manager there manipulated the prices of bond funds that were having losses. In April 2010, the SEC charged Morgan Keegan and two employees with civil fraud.

"The case is ongoing and we look forward to resolving this as soon as possible," a Morgan Keegan spokeswoman said.

Rated junk muni-bonds total about $54 billion in value, a small slice of the $2.9 trillion municipal debt market.

There also are nonrated junk muni bonds that are considered even riskier.

'Dirt Bonds'

Scrutiny of junk muni-bond values by the SEC includes "tobacco bonds" as well as "dirt bonds," according to people familiar with the matter.

Tobacco bonds have been sold by states and are backed by payments from tobacco companies that flow from legal settlements in the late 1990s.

Dirt bonds helped finance infrastructure for housing developments in U.S. states such as Florida and California. Homeowner assessments were supposed to cover the bond debt. But the housing downturn meant some developments weren't built, drying up the cash stream to pay the bond debt.

In some cases the bonds haven't changed hands for a few years, according to trading records of the bonds. In those instances, mutual funds hire pricing services to come up with a value.

The valuation controversy surfaced in a lawsuit filed in 2009 against OppenheimerFunds Inc., a unit of **Massachusetts Mutual Life Insurance** Co.

Investors in **Oppenheimer California Municipal Bond Fund** allege that the fund manager stated in prospectuses that securities were valued at "fair value" and that the fund operator would monitor the accuracy of prices used to value securities.

Instead, the lawsuit alleges, the California fund's assets were "greatly overvalued," resulting in overall inflated net asset values, or NAVs, for the fund.

The fund's net asset value tumbled to $6.36 a share in November 2008 from $11.44 per share in September 2006, a decrease of about 44%.

According to the lawsuit, pending in federal court in Denver, the average loss for similar funds during the same period was about 11.5%.

OppenheimerFunds has asked a judge to dismiss the suit, saying in court documents that the "Funds' assets were fairly valued ... using a consistent process that met all regulatory standards."

In a statement, OppenheimerFunds said that the lawsuit lacked merit and that "we continue to defend ourselves vigorously."

The firm's spokeswoman declined to comment on the SEC probe.

According to recent annual and semiannual reports, **OppenheimerFunds Rochester National Municipals Fund** has marked down the value of many of its dirt-bond holdings in some cases by as much as 50%.

Other large municipal high-yield investors include mutual funds run by Franklin Templeton Investments, a unit of **Franklin Resources** Inc.; Invesco Van Kampen, a unit of **Invesco** Ltd.; **Nuveen Investments** LLC; and **Goldman Sachs Group** Inc. Representatives for the funds declined to comment on the SEC probe.

A civil fraud lawsuit filed by the SEC in a 2003 case stemmed from similar valuation issues that the agency is examining now, people familiar with the matter said.

The agency accused **Heartland Advisors** Inc., some of the Milwaukee asset manager's executives and pricing service FT Interactive Data of fraud related to Heartland municipal-bond funds. The funds sustained declines in net asset values in 2000 when their holdings of some high-yield municipal bonds were written down.

'Deliberate Mispricing'

The write-down was an attempt to correct "months of deliberate mispricing," the SEC alleged.

In 2008, Heartland and some of its executives agreed to pay $3.9 million as part of a settlement. FT Interactive Data, owned by **Interactive Data** Corp., agreed in 2003 to pay a fine of $125,000 and adopt new valuation procedures for high-yield municipal securities. The companies and individuals concerned didn't admit or deny wrongdoing.