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Client Advisory

SEC Focuses on Advisers' Controls Over Valuation

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SEC Examination Priorities, Enforcement Action and Implementation of FAS 157 Dictate Re-examination of Valuation Policies, Procedures and Disclosures

Controls over valuation will be the number one focus area of investment adviser examinations, according to Lori Richards, Director of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations. Speaking March 20 at the IA Compliance Best Practices Summit in Washington, DC, she said particular emphasis would be placed on whether advisers have such controls and are implementing them when pricing structured products, illiquid securities and other difficult-to-price securities.[1]

Richards said examiners would look at whether the adviser "has adequate processes and procedures related to risk management, valuation, and accounting, whether it is following those procedures, and whether it has disclosed the risks of investments in illiquid securities to its clients." She emphasized the importance of accurate valuation, so that advisers do not overcharge fees based on inflated values of client assets. In the case of mutual and hedge funds, subscriptions and redemptions are based on the net asset value of the fund, which is presumed to reflect accurate values of the underlying assets. Inflated valuations could also result in overstatement of performance. Valuation inaccuracies in any of these contexts could be actionable under the antifraud provisions of the federal securities laws.

Richards' remarks about the examination program follow those of other SEC officials who have in the last year indicated that valuation will also be a priority in enforcement. The Commission underscored this in January when it announced the latest of three settlements of enforcement actions related to the valuation by Heartland Advisors, Inc. of certain bonds owned by two registered high-yield municipal bond funds it managed.[2] After the bonds were devalued in 2000 at a loss of $60 million to shareholders in the funds, the SEC brought actions against the senior officers, portfolio managers, traders and members of the pricing committee of Heartland for mispricing the bonds, and against the independent directors of the two funds for failing to heed warnings and take action to cause the bonds to be priced at their "fair value."

The heightened SEC scrutiny dovetails with action by the Financial Accounting Standards Board, which has issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("FAS 157").[3] Effective for financial statements for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years, FAS 157 establishes a framework for measuring fair value under generally accepted accounting principles ("GAAP") and is applicable whenever other accounting pronouncements require or permit "fair value" measurements. In the investment

1 The other nine of the top 10 focus areas are as follows: 2. controls over non-public information/personal trading/Code of Ethics; 3. dealing with senior investors; 4. compliance and supervision; 5. portfolio management (consistency with client objectives and restrictions); 6. brokerage arrangements and best execution; 7. allocation of trades; 8. performance advertising, marketing and fund distribution activities; 9. safety of clients' and funds' assets; and 10. information processing and protection. For further details on each of these topics, the speech may be found at http://www.sec.gov/news/speech/2008/spch032008lar.htm.

2 *In re Heartland Advisors, Inc.*, Securities Act Release No. 8884, January 25, 2008; *see also In re Hammes*, Securities Act Release No. 8346, December 11, 2003, and *SEC v. Heartland Group, Inc.* (N.D. Ill.), Litigation Release No. 16938 (March 22, 2001).

3 The full text of Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" can be found at http://www.fasb.org/pdf/fas157.pdf.

management arena, it will apply to registered investment companies, hedge funds that issue GAAP financial statements (as required to avoid reporting under the Investment Advisers Act custody rule) and valuations by investment advisers for other clients requiring information under GAAP. However, there are issues concerning the manner in which FAS 157 will be applied to financial statements of various entities. We recommend that you discuss the impact of FAS 157 on your financial reporting with your accountants as soon as possible.

According to the FASB's Executive Summary, FAS 157 seeks to address uncertainty surrounding valuation by standardizing the definition of fair value, clarifying the methods to be used in measuring fair value and expanding required disclosures about fair value measurements. FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market at the measurement date. The definition focuses on the price that would be received to sell the asset or paid to transfer the liability (the exit price) and not on the price that would be paid to acquire the asset or received to assume the liability (the entry price).

FAS 157 states that fair value is a market-based measurement, not an entity-specific measurement, and should be determined based on the assumptions that market participants would use in valuing an asset.[4] FAS 157 establishes a three-level fair value hierarchy. Entities must use inputs for measuring fair value beginning with the highest level possible (Level 1), and where not available, going to the next lower level. The three levels for measuring fair value are as follows:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Examples include:
  - Quoted prices for similar assets or liabilities in active markets;
  - Quoted prices for identical or similar assets or liabilities in markets that are not active (e.g., brokered markets); and
  - Inputs other than quoted prices that are observable for the asset or liability (e.g., interest rates, credit risks and default rates).
- Level 3 inputs are unobservable inputs for the asset or liability.
  - Level 3 inputs are intended to be used in situations where there is little, if any, market activity for the asset or liability at the measurement date; and
  - Unobservable inputs should reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk and the effect of a restriction on the sale or use of an asset).

FAS 157 also expands disclosure requirements with respect to fair valuation. For assets and liabilities measured at fair value on a recurring basis, the reporting entity must disclose information including the fair value measurements at the end of the period and the inputs used to create those fair values. For recurring fair valuations using significant unobservable (Level 3) inputs, the reporting entity must disclose the effects of the fair value measurements on earnings (or changes in net assets) for the period.

FAS 157 deviates slightly in concept from guidance under the Investment Company Act, which previously generated the most well-developed SEC interpretive material on valuation because of the need to price mutual funds daily. The Investment Company Act generally provides that securities for which market quotations are readily available shall be valued at their market value, and all other securities shall be valued in good faith at their fair value. FAS 157 eliminates this dichotomy between market and fair value, instead treating readily available market quotations for the security being valued as Level 1 inputs for determining the fair value of securities that have such quotations.

4 Because Katten Muchin Rosenman LLP is a law firm, not an accounting firm, we defer to accounting professionals to determine how the terms of FAS 157 should be interpreted and implemented in specific cases.

The heightened scrutiny by the SEC in this area, evidenced both by stated examination policy and in enforcement action, together with changes in accounting methodology, emphasizes the need for investment management firms to review their valuation policies and procedures and related disclosures to investors.

For Additional Information

Katten has formed a task force of attorneys experienced in advising managers on the valuation process and developing valuation procedures for investment advisers to mutual funds, hedge funds and separate account clients, including procedures reflecting FAS 157. We can work with your accountants and pricing services to develop policies and procedures suited to your investments:

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