

Risk Management Update January 2015

VALUATION – WHAT INVESTMENT ADVISERS SHOULD KNOW

In the release of Rule 206(4)-7 of the Investment Advisers Act of 1940, which was issued in December 2003 mandating investment advisers to adopt compliance programs¹ (“Compliance Program Rule”), the Securities and Exchange Commission (“SEC”) outlined that such firms must implement policies and procedures covering, among other things, the “processes to value client holdings and assess fees based on those valuations.” Even though it has been over 11 years since the Compliance Program Rule was adopted, valuation is an area that can sometimes be overlooked, and even abused by investment advisers.

Notably, since the issuance of the Compliance Program Rule, the SEC has brought a number of enforcement cases against advisory firms involving misrepresentation and fraud surrounding valuation of clients’ securities holdings. Below is a sampling list of the allegations raised against advisers by the SEC in some of these enforcement cases:

1. Valuing investments at cost despite knowledge of the investment being severely impaired, and continuing to charge advisory fees on the full cost of each investment².
2. Overvaluing private fund illiquid assets held in a “side pocket”, reporting inflated net asset values to investors, and charging excessive management fees to the private fund³.
3. Failing to follow stated valuation policies, ignoring negative information pertaining to private fund investments, withholding information from fund auditors, and misleading investors regarding liquidity of the private fund and the use of a third party valuation firm⁴.
4. Failing to value fixed income holdings in accordance with the mutual fund’s written valuation procedures and causing misstatements in the mutual fund’s daily net asset value⁵.

The Role of the Investment Adviser

As a fiduciary, advisory firms have an ongoing responsibility to act in their clients’ best interest. With respect to valuation, that means having policies, procedures, and internal controls in place to ensure the accurate valuation of securities held in clients’ accounts and that asset based advisory fees are assessed properly. When implementing such practices, advisers need to consider a variety of issues, including but not limited to: (i) the types of securities invested in clients’ accounts, (ii) the liquidity and market risks

¹ See “Compliance Programs of Investment Companies and Investment Advisers” (Release Nos. IA-2204; IC-26299; File No. S7-03-03) at <http://www.sec.gov/rules/final/ia-2204.htm>

² In the Matter of Cornerstone Capital Management, Inc. and Laura Jean Kent (Release No. 2855 / March 20, 2009) <http://www.sec.gov/litigation/admin/2009/ia-2855.pdf>

³ SEC v. Paul T. Mannion, Jr., Andrew S. Reckles, PEF Advisors LLC, and PEF Advisors Ltd. (Litigation Release No. 21699 / October 19, 2010) <http://www.sec.gov/litigation/litreleases/2010/lr21699.htm>

⁴ SEC v. Yorkville Advisors, LLC, Mark Angelo and Edward Schinik (Litigation Release No. 22510 / October 17, 2012) <http://www.sec.gov/litigation/litreleases/2012/lr22510.htm>

⁵ In the Matter of UBS Global Asset Management (Americas) Inc. (Release Nos. IA-3356; IC-29920 / January 17, 2012) <http://www.sec.gov/litigation/admin/2012/ia-3356.pdf>

surrounding the securities, (iii) the party(ies) responsible for pricing/valuation (*i.e.*, custodian, issuer, and/or adviser), (iv) the timing and frequency of the valuations, (v) the process used by the custodian or issuer in valuing the securities, (v) the method used for reporting to clients, and (vi) the protocols for assessing advisory fees.

It is also important that firms consider the types of clients they have, which may necessitate adherence to additional regulations. For example, investment advisers who manage the portfolios of registered investment companies (*i.e.*, mutual funds) are also required to adhere to the written policies and procedures of the mutual funds, which are mandated under the Investment Company Act of 1940, (as amended). Advisers that manage private retirement plan assets must also adhere to the regulations under the Employee Retirement Income Security Act of 1974 (“ERISA”).

Valuation processes play a significant role when calculating performance. Importantly, firms claiming compliance with the Global Investment Performance Standards (“GIPS®”) must adhere to the GIPS® Valuation Principles outlined in the GIPS® 2010 Handbook⁶, along with any Guidance Statements pertaining to valuation that were adopted thereafter⁷. Nevertheless, even though the GIPS® principles and statements are only required to be followed by advisory firms claiming compliance, other firms may want to consider using them as guidelines.

There may be circumstances that require an investment adviser to determine a “fair market value” price for a security, such as when a security price becomes stale, stops trading, or for certain privately held securities. To be prepared for these events, a firm should have detailed fair valuation procedures in place that include, at a minimum:

- the person(s) responsible for providing a valuation analysis;
- the inputs that should be considered when determining a valuation;
- the frequency required for the valuations;
- the documentation necessary to substantiate the valuation; and
- the person(s) responsible for approving the valuation.

The SEC has issued guidance over the years, mainly pertaining to the fair valuation of securities held in mutual fund portfolios, stating that fair value must be based on arm’s length considerations of what price would apply upon a current sale and not determined on the expectation of a future sale. In other words, an adviser would not be able to value a non trading fixed income security at par simply because the adviser planned to hold the security until maturity.

Lastly, advisory firms must ensure that they have solid internal controls in place for the calculation of asset based advisory fees, and that the controls specifically take into account the valuation steps pertaining to the different types of securities in clients’ accounts.

⁶ See 2010 Edition of GIPS® Handbook at <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n5.1>

⁷ See <http://www.gipsstandards.org/standards/Pages/index.aspx>

Core Compliance Steps for Valuation and Fee Assessment

While all registered investment advisers are required to have a system for valuation and fee assessment, processes will vary depending mainly upon the types of investments utilized, classification of clients, and the size of the firm. Below are some compliance steps for consideration that generally apply to all advisory firms:

1. Assign a Valuation Committee for oversight of the valuation process (small firms can appoint a senior manager in addition to the CCO for oversight of valuations).
2. Identify and mitigate (or eliminate to the extent possible) all risks and conflicts surrounding valuation of securities in client accounts.
3. Include a list in the firm's policies and procedures of applicable types of securities that require valuation.
4. Perform periodic testing of prices reported by clients' custodians.
5. Maintain a "Watch List" identifying thinly traded securities for fair valuation purposes.
6. Implement a process to identify and document reasons for similar securities that are fair valued differently.
7. Have controls in place for identifying significant market events that effect prices/valuations.
8. Implement a process for identifying stale prices (definition may vary depending on type of security).
9. Utilize "look back" testing to determine adequacy of process.
10. Perform due diligence on pricing services, custodians and issuers, as applicable.
11. Maintain documentation of all identified risks and conflicts, Valuation Committee meetings, Watch Lists, fair valuation determinations, exception reports, price overrides, and due diligence reviews.
12. Provide clear disclosures to clients regarding valuation processes in advisory agreements, Form ADV, Prospectus and Statement of Additional Information, and private fund offering documents, as applicable.
13. Perform testing to ensure that valuation processes match disclosures to clients.
14. Train supervised persons on the firm's valuation process.
15. Utilize technology to the extent possible to assist with valuation process.

Conclusion

The processes used by investment advisers for valuation, performance calculation, and fee assessment continue to be one of the SEC's top focus areas. However, investment advisers that have robust compliance controls and solid policies and procedures in place will be equipped to address and mitigate risks and conflicts surrounding valuation, and also will be well prepared for regulatory scrutiny.

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