Fallout From Credit Crunch: Heightened Scrutiny of Adviser Security Valuation

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The ripple effects of the subprime crisis continues as U.S. regulators have inquired how the biggest firms value derivative securities, particularly those backed by subprime instruments. Broker-dealers that are significant players in the subprime market are receiving targeted examination from regulators with a focus on valuation, pricing transparency, controls over pricing and collateral monitoring. The SEC is also examining how accurately mutual funds are valuing their hard-to-value securities. The recent announcements by Wall Street financial powerhouses of write-downs of some of their investments has increased the regulator's scrutiny of valuation. Morgan Stanley, Lehman Brothers Holdings, Inc., Bear Stearns and Merrill Lynch recently announced write-downs for mortgage, leverage loans and other assets that have plunged in value. In addition, banks, brokers and hedge funds continue to struggle to sell securities related to certain mortgages, and as the liquidity dries up, the securities become harder to value.

Published mutual fund exposure to subprime mortgages so far has been by way of mortgage- and asset-backed securities or collateralized debt obligations ("CDO"), a security backed by a pool of loans or other fixed income securities. Some money market funds have had to confront difficult pricing issues because of the credit crunch. In addition to CDOs, the recent credit crunch has also increased the focus on fund valuation of other derivative instruments. As a result of the increased focus, investment advisers and mutual fund boards should review their policies and procedures to determine: (1) the accuracy of how derivative securities are priced in the first instance; and (2) the reliability of fair value procedures if and when the derivative security should be fair valued.

Fair Value Standards

In September 2006, the Financial Accounting Standards Board ("FASB") issued FAS Statement No. 157, "Fair Value Measurements," which is effective for financial statements issued for fiscal years beginning after November 15, 2007. The new standard requires that firms divide their assets into three categories (Level 1, 2 or 3). Level 1 assets are marked-to-market assets. Level 2 "marking-to-matrix" assets are valuations based on "observable market data" of similar assets. Level 3 "marking-to-model" assets are valuations based on unobservable inputs reflecting management's best judgment. The Level 3 process can employ pricing models based on estimates of futures cash flows or other formulas. "Level 3 assets" is now the phrase in the industry for hard-to-value assets.

Mutual funds generally are disclosing in shareholder reports that the funds are reviewing the impact of FAS 157 and will provide additional disclosure next year. Generally, the new standard does not change the valuation procedures funds follow but the funds, when they do comply with FAS 157, will have to grade the portfolio assets Level 1, 2 or 3. Separately, mutual funds are already subject to fair valuation requirements. Securities for which market quotations are "readily available" must be valued at market value, and all other securities and other assets must be valued at "fair value" as determined in good faith by a fund's board of directors. According to guidance from the SEC, a board may delegate to the investment adviser or others the actual fair value determinations so long as the board reviews and approves the methodology by which fair value determinations are made and regularly reviews the appropriateness and accuracy of the valuation. All funds must adopt written policies and procedures governing the fair valuation of their securities. As a general principal, a security's fair value is the price that the fund might reasonably expect to receive upon its current sale.

The importance of fair value procedures and recordkeeping, as well as internal controls, was highlighted in June 2007 when the SEC settled an administrative enforcement action against a closed-end management company (the "Company") that is regulated as a business development company. The SEC alleged that the Company, which fair valued approximately 65% of its total assets, failed to make and keep books, records and accounts sufficient to support the valuation of certain securities for which market quotations were not readily available. The Company also allegedly failed to maintain a system of internal accounting controls sufficient to provide reasonable assurance that valuations were fairly stated in accordance with generally accepted accounting principals. The settlement required that the Company continue to employ a chief valuation officer and receive quarterly assistance from independent valuation consultants.

Pricing Derivative Securities - Questions that Should be Asked

A recent speech by an SEC staff member highlights questions that should be asked about derivative investments. At the Mutual Fund Directors Forum Program on November 8, 2007, Gene Gohlke, Associate Director, Office of Compliance Inspection and Examinations of the SEC, discussed areas of risk that a fund director should consider when funds invest in derivative instruments. Initial questions directors should ask include: (1) does the adviser have the intellectual and financial resources to knowledgably invest in derivatives; (2) does the adviser have a due diligence or new products process through which every proposed derivative investment is vetted from all operational areas; and (3) does the adviser have an ongoing risk management system in place to monitor the derivative investments.

With respect to derivative valuation issues, Mr. Gohlke highlighted the following questions directors should ask:

1. What is the process used to measure and monitor the fund's liquidity/illiquidity?

2. What are the processes for defining, measuring and monitoring the fund's leverage as a result of its derivative positions?

3. Are the values for the fund's positions used in calculating its net asset value ("NAV") reasonable in light of current market conditions? Specifically, do the processes used to value the fund's derivative positions, including the use of the fair value procedures adopted by the Board, provide substantial assurance that the value used each day for each derivative position held by the fund will reflect an amount the fund could reasonably expect to realize on that position.

At the November 14, 2007 "CCOutreach" national seminar, Mr. Gohlke indicated that, while recent SEC examinations have focused on valuation policies and procedures, the agency is considering a more comprehensive look at derivative pricing. The credit crunch has made it hard for some derivative securities to be valued, resulting in more fair valuation of these securities. Advisers, including their Chief Compliance Officer, should periodically test the price quotes of these securities, which can be done a number of ways including obtaining feedback from portfolio managers on broker quotes. Another SEC official at the seminar noted that advisers should be wary of “accommodation pricing,” which is when a broker provides a quote expecting it will not have to execute a trade at the quote.

In addition, if a fund does invest in derivative securities, directors should specifically inquire whether the fund has any direct or indirect exposure to subprime mortgage investments. Advisers should provide directors information as to the nature and extent of any “indirect” subprime exposure. Directors should also inquire as to how mortgage and asset-backed securities are being valued.

The subprime and liquidity crunch has highlighted the importance and increased the regulatory scrutiny of security valuation. Advisers, investment companies and other financial organizations should ensure they have adequate valuation procedures, processes, recordkeeping and internal controls, and that their security valuations are appropriate.

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