



Voltaire
ADVISORS

Valuation, Liquidity & Derivatives

MARRIOTT MARQUIS, NEW YORK CITY, 11TH FEBRUARY 2016



Introduction

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MANAGING DIRECTOR
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Morning Agenda

- ◆ 0900 Introduction – Ian Blance, Voltaire Advisors
- ◆ 0915 Updated Valuation Guidance from the SEC – Ron Feiman, Kramer Levin
- ◆ 0945 Fair Valuation in Practice – Rajan Chari, Deloitte
- ◆ 1015 Coffee
- ◆ 1045 SEC Guidance on Use of Pricing Services – Ian Blance, Voltaire Advisors
- ◆ 1115 Due Diligence in the New Regulatory Regime – Karl Mackelburg, Thomson Reuters
- ◆ 1145 Panel Discussion – Latest Guidance on Mutual Fund Valuation
 - Ian Blance | Ron Feiman | Chris Franzek | Karl Mackelburg
- ◆ 1215 Lunch

Opening Remarks



Regulator
focus on Buy-
Side (SIFI
debate)

The diagram consists of three dark purple circles arranged horizontally. The first circle on the left contains the text 'Regulator focus on Buy-Side (SIFI debate)'. A large grey plus sign is positioned between the first and second circles. The second circle in the middle contains the text 'Policy makers assessments of the recent financial crisis'. A large grey equals sign is positioned between the second and third circles. The third circle on the right contains the text 'Significant on-going attention to fund policies & procedures'. In the background, there is a large, faint, light grey graphic of a globe with horizontal lines.

Policy makers
assessments
of the recent
financial crisis

Significant
on-going
attention to
fund policies
& procedures

- ◆ Highly evolved mutual fund valuation rules and guidance developed over last 40 years
- ◆ 1940 Act provisions and rules supplemented by a series of releases and staff guidance letters
- ◆ Most recently Release 33-9616 on Money Market Reform in 2014
<https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679>
- ◆ Follows Morgan Keegan, Yorkville & KCAP enforcements in 2012
- ◆ Have the lessons been learned?
- ◆ AlphaBridge July 2015!

“The integrity of the portfolio valuation process is critical to fund investors, especially when it involves illiquid securities,”

Julie M. Riewe, Co-Chief of the SEC Enforcement Division’s Asset Management Unit, 2015

- ◆ Rule reforms proposed in September 2015
 - <https://www.sec.gov/news/pressrelease/2015-201.html>
- ◆ Proposed rule 22e-4 will require open-end investment companies and ETF's to implement a comprehensive liquidity risk management program
- ◆ Multiple components:
 - Classification of the liquidity of fund portfolio assets;
 - Assessment, periodic review and management of a fund's liquidity risk;
 - Establishment of a three-day liquid asset minimum; and
 - Board approval and review.
- ◆ 'Swing Pricing'
- ◆ Disclosures in N1-A, N-PORT & N-CEN

Derivatives Proposals

- ◆ Happy Holidays from the SEC!
- ◆ Dec 2015 proposals to limit use of derivatives and require implementation of a comprehensive risk management program
<https://www.sec.gov/news/pressrelease/2015-276.html>
- ◆ Either exposure- or risk-based limits to the use of derivatives
- ◆ Segregation of cash to cover derivative exit costs (based on mark-to-market calculation) plus additional risk-based amount to allow for stressed exits
- ◆ Establishment of derivatives risk management program and designated derivatives risk manager for funds engaging in 'more than limited' derivatives use
- ◆ Disclosure in N-PORT and N-CEN

FATCA

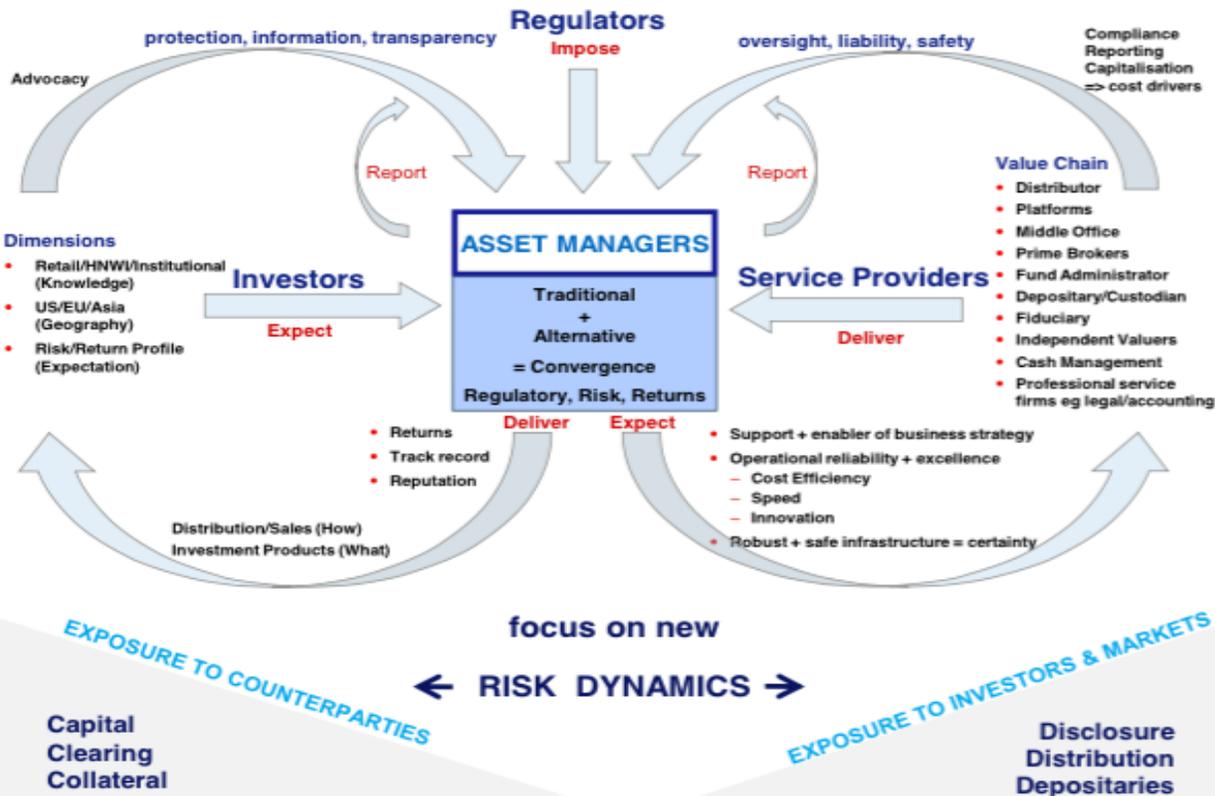
US Foreign Account Tax Compliance Act

Timeline

- Signed into law in March 2010; from Aug 2013 IRS online registration available
- From July 2014 withholding and FATCA compliant procedures must be in place

Key Themes

- **Rationale:** prevent tax evasion by US investors through non-US accounts; **FDIP income** is fixed, determinable, annual or periodical income sourced in US
- **Foreign Financial Institutions FFI** defined as holding financial assets for the accounts of others; can enter into an agreement with US authority IRS to be identified as participating **PFFI**; entails duty to report to US authorities any accounts held by US investors; local reporting possible where countries have signed Intergovernmental Agreement (IGA) with the US IRS
- Non-participating **N-PFFIs** will be subject to **30 % tax withholding** of all US-sourced payments such as dividends/interests paid by US corporates
- **Operational challenges:** to identify end-investor, to verify as US citizen through chain of intermediaries; new documentation and investor disclosure requirement towards US authorities; change of IT systems
- Applies also to "pass-through payments" including those "attributable to" withholdable payments/US sourced income resulting in a wide scope



AIFMD

EU Alternative Investment Fund Managers Directive

Timeline

- Level 1 Directive in force since July 2011; effective for industry from July 2013
- Level 2 final delegated regulation adopted in Dec 2012, in force from July 2013

Key Themes

- **Applicable:** to **non-UCITS funds**, including hedge funds, private equity
- **EU domicile:** applicable if the alternative fund (AIF) or manager (AIFM) or investor is domiciled in one of the EU 28 member states or 3 EEA countries
- **Passport:** EU managers can apply for a passport from July 2013 (equivalent concept to UCITS); for non-EU managers from 2015, until then private placement
- **Third-country / marketing rules:** non-EU funds eg domiciled in Cayman, Guernsey, Jersey, Switzerland etc will require prior authorisation in EU
- **Reporting obligation:** regarding investment strategies, risk management, governance, remuneration: disclosure required to both, regulators and investors
- **Delegation:** similar to UCITS/MiFID, but aims to prevent any potential approach by service providers of "outsourcing risk or liabilities"
- **Depository liability rules outlined below:** a single depository for each AIF needs to be appointed for all non-UCITS funds; impact on fund economics

UCITS IV / V

EU Mutual Funds

Timeline

- UCITS IV in force and mostly implemented by EU 28 member states
- UCITS V proposal published in July 2012; target industry effective date end 2014

Key Themes

- **Passport:** in force for management companies
- **Marketing rules / KIID:** Key Investor Information Document will be further standardised + have more information on risk, calculation methodology, charges
- **Master-feeder structures:** a more harmonised approach across Europe may stimulate growth in cross-border pooling and mergers, but tax issues remain
- **"NEWUCITS":** HF managers offering more UCITS products since the possible inclusion of **derivatives** tapping into new investor segments + target markets
- **Depository: new liability rules as in AIFMD** expected spill over into UCITS V whereby depositaries are
 - liable for the loss of financial instruments held in custody
 - have the obligation to return corresponding amount without undue delay
 - only following the return may prove - cumulatively - that the loss is a result of
 - 1) an external event, 2) beyond its reasonable control,
 - 3) the consequence was unavoidable, 4) despite efforts to the contrary

DODD-FRANK-ACT / VOLCKER / CFTC

US comprehensive rules reforming financial services

Timeline

- Signed into law in July 2010; phased implementation
- Dodd-Frank effective from July 2011; Volcker Rule phased from July 2012

Key Themes

- **US/non-US investment advisors** need to register with the US SEC if AUM greater than USD \$100/25 million respectively attributable to US investors
- **Consequence are stricter record keeping, reporting requirements, oversight and inspection** on eg AUM, capital leverage ratios, counter-party credit risk exposure, trading and investment positions, valuation policies, liquidity and short selling provisions, books and records retention: **Form PF for HFs**
- **US CFTC** regulates swaps; has identified 38 areas divided into 8 sections: swap dealers, clearing, trading, data, products, enforcement, position limits, other
- **Volcker Rule** mandates the segregation of banking and proprietary trading and from sponsoring or investing in AI management functions; leading to spin-offs of proprietary trading desks, HF/PE arms by banks (UK equivalent "Vickers report")
- **Central clearing of OTC derivatives** same concept as European EMIR rules agreed by the G20 in 2009

BASEL III

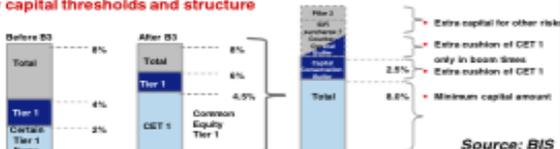
Global Capital Rules for Banks & Insurance

Timeline

- **Banking:** G20 -> by end 2012; EU CRD IV; US Dodd Frank Act provisions
- **Insurance:** EU Solvency II by 2015 - similar aim as B3 for insurance sector

Key Themes

- **De-risking/-leveraging:** new global standards designed to strengthen capital and liquidity; stress testing; creating a more robust and resilient banking sector
- **Systemically important financial institutions (SIFIs)** to have loss absorbing capacity beyond existing standards; "living-wills" recovery & resolution plan **RRP**
- Higher risk weightings on **derivatives**; 2% against initial margin posted to the CCP; clearing members to hold capital against exposure to clients
- **New capital thresholds and structure**



EMIR

European Market Infrastructure Regulation

Timeline

- EMIR entered into force Aug 2012; technical standards in force from March 2013
- Industry implementation phased from Jan 2013 onwards (G20 commitment)

Key Themes

- **Central clearing of OTC/ETD derivatives through a CCP** similar to US Dodd-Frank; otherwise capital charges apply; need to **review risk management**
- **Common governance standards for CCPs** and pan-EU requirements for CCP interoperability regarding equities; third country CCPs need to meet new EU standards if used by EU counterparties
- **Increased margin and collateral requirements:** portability and eligibility of collateral not yet finalised, eg required is "highly liquid collateral"
- **Operationally** need to review number and type of collateral relationships with clearing brokers factoring in all risk management aspects & optimization
- **Mandatory daily independent valuation and collateralisation** of those trades that are not cleared through a CCP centrally
- **Trade repositories:** mandatory reporting of all derivative contracts

MiFID/R II

EU Markets in Financial Instruments Directive

Timeline

- MiFID II Regulation & Directive proposal published in Oct 2011
- Industry implementation targeted from 2015 or after

Key Themes

- **Wider scope in 3 aspects:** 1) new instruments, 2) venues, 3) activities; captured will be eg: almost any type of derivatives; organised trading facilities (OTFs), "dark pools"; high frequency / algo / auto trading activities
- **Derivatives on-exchange trading (ETD):** if sufficiently liquid (standardized) derivatives shall be traded on-exchange; then cleared centrally (EMIR)
- **Commodity derivatives** under review re efficient functioning of its hedging and price discovery purpose; potential position limits designed to support liquidity, greater investor transparency through aggregated weekly market breakdown
- **Structured UCITS classified as complex products - marketing impact:** MiFID sales and transparency rules will apply; increased operational complexity
- **Depository:** now classified as "investment advice" instead of just "ancillary service" under the EU Securities Law Legislation and consequently under MiFID increasing compliance requirements and costs

SHORT SELLING (SSR)

Short Selling Regulation and Credit Default Swaps

Timeline

- Adopted in Sep 2011; effective for industry from Nov 2012

Key Themes

- EU regs **ban uncovered sovereign CDS** but member states can suspend rules
- **Covered** short sales require share to be "located" & settlement can be effected
- Ongoing duty to **report net short positions** to regulators (>0.2%) and publicly to market (>0.5%) on named basis plus for each 0.1% increase above the threshold

MAD/R II

EU Market Abuse Directive / Regulation

Timeline

- Proposal published in Oct 2011; possibly effective for industry from Jan 2015

Key Themes

- **Wider scope:** 1) new instruments, eg OTC & commodity derivatives; 2) markets, eg MTFs & other venues; 3) behaviours, eg attempts to manipulate the market including manipulation of any benchmark or index eg LIBOR rate-fixing

FTT

Financial Transaction Tax

Timeline

- **France:** effective for industry from Aug 2012; other EU countries may follow
- **EU:** issued proposal in Sep 2011 for Dec 2014, pan-EU enhanced cooperation

Key Themes

- **0.1%** for transactions in equities (& bonds; **0.01%** of notional derivatives value)
- **EU:** potential very wide scope: all markets, all instruments, all actors in FTT land

“

Confusion now hath made his masterpiece

”

WILLIAM SHAKESPEARE, *MACBETH*



Updated Valuation Guidance from the SEC

RON FEIMAN
PARTNER
**KRAMER LEVIN NAFTALIS &
FRANKEL LLP**





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KRAMER LEVIN NAFTALIS & FRANKEL LLP

Valuation Issues for Registered Investment Companies

February 11, 2016



WHAT'S NEW?

- **9/22/15 – Liquidity Risk Management proposing release**

if a fund finds that it can only sell portfolio assets (or portions of a position in a particular asset) that are **less liquid at** prices that incorporate a significant **discount from fair value**, the discounted sale price can materially affect the fund's NAV

- **7/23/14 – Money Market Fund Reform adopting release**

Before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, the fund's board of directors may want to consider the **inputs, methods, models, and assumptions** used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change

- **6/13/13 – Morgan Keegan settlement**



WHAT'S FOUNDATIONAL? Net Asset Value

1940 Act:

Section 2(a)(32) - “Redeemable security” means any security ... the holder ... is entitled ... to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent

1968 Rule 22c-1 (as amended 1979, 1985, 1993) .

- (a) No registered investment company issuing any redeemable security... shall sell, redeem, or repurchase any such security except at a price based on the current **net asset value** of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security

Section 2(a)(41)(B) – “Value” means ... (i) with respect to securities for which market quotations are readily available, the market value of such securities; and (ii) with respect to other securities and assets, fair value as determined in good faith by the board of directors [formerly numbered as Section 2(a)(39)]

Rule 2a-4 (1964) - Definition of “current net asset value” ...used in computing periodically the current price for the purpose of distribution, redemption, and repurchase means an amount which reflects ...
(1) Portfolio securities with respect to which market quotations are readily available shall be valued at current market value, and other securities and assets shall be valued at fair value

Valuation Issues for Investment Companies

1969 Accounting Series Release 113

“For the year 1968 ... open-end funds accounted for about \$3.2 billion of ... restricted securities which represented 4.4% of their net assets.”

Readily available market quotations refers to reports of current public quotations for securities similar in all respects to the securities in question. No such current public quotations can exist in the case of restricted securities.... Accordingly, their fair values must be determined in good faith by the board

the current fair value of restricted securities would appear to be the amount which the owner might reasonably expect to receive for them upon their current sale. [T]his depends upon their inherent worth, without regard to the restrictive feature, adjusted for any diminution in value resulting from the restrictive feature.

It is the responsibility of the board of directors to determine the fair value of each issue of restricted securities in good faith; and the data and information considered and the analysis ... thereof should be retained for inspection by the company's independent auditors. While the board may, consistent with this responsibility, determine the method of valuing each issue of restricted security in the company's portfolio, it must continuously review the appropriateness of any method so determined. The actual calculations may be made by persons acting pursuant to the direction of the board.

Valuation Issues for Investment Companies

1969 Accounting Series Release 113 (continued)

[A]utomatic valuation of restricted securities [at a fixed discount from registered shares] ... would ... not... satisfy the requirement of the Act that each security, for which a market quotation is not readily available, be valued at fair value as determined in good faith

assumes that the market price for unrestricted securities of the same class is representative of the fair value of the securities. This may not be the case when the **market** for the unrestricted securities is **very thin**.... [T]he news of the investment company's purchase of the restricted securities may...lead to. a spiralling **increase** in the valuation of both the restricted and unrestricted securities.

In summary, there can be no automatic formula by which an investment company can value restricted securities in its portfolio

Valuation Issues for Investment Companies

1970 Accounting Series Release 118

In some circumstances **value can be determined fairly in more than one way**.... A company's stated valuation policies should be consistent

Securities listed or traded on a national securities exchange. ...Some companies as a matter of general policy use the bid price, others use the mean of the bid and asked prices, and still others use a valuation within the range considered best to represent the value in the circumstances; each of these policies is acceptable if consistently applied.

If sales have been infrequent or there is a thin market in the security, further consideration should be given to whether "market quotations are readily available."

Over-the-counter securities.... quotations generally are in the form of inter-dealer bid and asked prices. Because of the availability of multiple sources, a company frequently has a greater number of options open to it in valuing securities traded in the over-the-counter market than it does in valuing listed securities. A company may adopt a policy of using a mean of the bid prices, or of the bid and asked prices, or of the prices of a representative selection of broker-dealers quoting on a particular security; or it may use a valuation within the range of bid and asked prices considered best to represent value in the circumstances. Any of these policies is acceptable if consistently applied.

Valuation Issues for Investment Companies

1970 Accounting Series Release 118 (continued)

Securities valued "In good faith". ... it is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, **the board may appoint persons to assist them in the determination of such value, and to make the actual calculations** pursuant to the board's direction. The board must also, consistent with this responsibility, **continuously review the appropriateness** of the method used in valuing each issue....

As a general principle, the current **"fair value"** of an issue of securities being valued by the Board of Directors would appear to be **the amount which the owner might reasonably expect to receive for them upon their current sale.**

Some of the general factors which the directors should consider in determining a valuation method for an individual issue of securities include: (1) The fundamental analytical data relating to the investment, (2) the nature and duration of restrictions on disposition of the securities, and (3) an evaluation of the forces which influence the market.... Among the more specific factors which are to be considered are: type of security, financial statements, cost at date of purchase, size of holding, discount from market value of unrestricted securities of the same class at time of purchase, special reports prepared by analysts, information as to any transactions or offers with respect to the security, existence of merger proposals or tender offers affecting the securities, price and extent of public trading in similar securities of the issuer or comparable companies

Use of Valuation Committees

1973 – Paul Revere Investors Inc. *no action letter* –

- [No action if the fund] establishes ... [a] Securities Valuation Committee and procedures for the purpose of valuation of the Company's restricted securities between meetings of the Board of Directors
- [It was] contemplated that both the Board and management be represented
- The Board would meet no less often than quarterly to review, and if necessary amend, the guidelines
- the Committee has the duty and responsibility to advise the Board of Directors at any time it believes that the methods established for valuing any restricted security or securities are erroneous so that the Board may determine whether such methods should be modified
- we assume that that the proposed valuation procedure for restricted securities would also be used for unrestricted securities for which no market quotations are readily available



Readily Available Market Quotations – the slippery slope

1981 – Putnam Growth Fund and Putnam International Equities Fund **no action letter** –

It's appropriate to value foreign securities based on market quotations ordinarily, but to fair value them if “**an event has occurred** since the time a value was so established that is likely to have resulted in a change in such value, in which case the fair value” would be used

1984 – Amendment to Rule 22c-1 (citing Putnam)

[i]f an event does occur which will affect the value of portfolio securities **after the market has closed**, the fund must, to the best of its ability, determine the fair value

Valuation Issues for Investment Companies

1999 – ICI Letter regarding Valuation Issues (Doug Scheidt)

securities are not readily available when the exchanges or markets on which those securities trade do not open for trading for the **entire day**.... Whether the NYSE could otherwise be considered to be closed on any given day depends on the particular facts and circumstances

funds encounter difficulties in selling or pricing their portfolio securities due to, among other things, market breaks, trading restrictions, internal fund failures, or **natural disasters**.... following September's earthquake in Taiwan, the Taiwan Stock Exchange ("TSE") was closed for a number of days. We believe that **under these circumstances, market prices** for securities traded on the TSE **were not "readily available"** In anticipation of circumstances such as these, funds should consider adopting procedures that are designed to alert the board and fund management to conditions that may necessitate fair value pricing

ASRs ... were not intended to provide comprehensive guidance to funds on how to address all pricing issues

different fund boards, or funds in the same complex with different boards, when fair value pricing identical securities, could reasonably arrive at prices that were not the same, consistent with the boards' obligation to fair value price in good faith

boards, however, typically are only indirectly involved in the day-to-day pricing of a fund's portfolio securities. Most **boards fulfill their obligations by reviewing and approving pricing methodologies**, which may be formulated by the board, but more typically are recommended and applied by fund management.

When the board has vested a **comparatively greater amount of discretion in fund management**, or when pricing procedures are relatively vague, we believe that the **board's involvement must be greater** and more immediate.

Valuation Issues for Investment Companies

1999 – ICI Letter regarding Valuation Issues (Doug Scheidt)

In reviewing and approving pricing procedures, boards should determine whether those methodologies and procedures are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale.... the board [must] **periodically review the appropriateness of the methods** used to fair value price portfolio securities **and the quality of the prices obtained** through these procedures, and that it make changes when appropriate.

The following **list of factors** that fund boards may need to consider, if relevant, when fair value pricing portfolio securities is merely illustrative, and is not intended to preclude a board's consideration of any other factors. The factors include: the value of other financial instruments, including derivative securities, traded on other markets or among dealers; trading volumes on markets, exchanges, or among dealers; values of baskets of securities traded on other markets, exchanges, or among dealers; changes in interest rates; observations from financial institutions; government (domestic or foreign) actions or pronouncements; and other news events. With respect to securities traded on foreign markets, the factors also might include the value of foreign securities traded on other foreign markets, ADR trading, closed-end fund trading, foreign currency exchange activity, and the trading prices of financial products that are tied to baskets of foreign securities.... a fund board, when fair value pricing portfolio securities in an emergency or other unusual situation, should evaluate the nature and duration of the event and the forces influencing the operation of the financial markets. The board also should evaluate factors relating to the event that precipitated the problem, whether the event is likely to recur, whether the effects of the event are isolated or whether they affect entire markets, countries, or regions

Valuation Issues for Investment Companies

2001 – ICI Letter regarding Valuation Issues (Doug Scheidt)

the closing prices of securities that principally trade on foreign exchanges or markets ("foreign securities") may be as much as 12-15 hours old by the time of the funds' NAV calculation, and may not reflect the current market values of those securities at that time ... [i]n particular ... if an event that will affect the value of those securities ("significant event") has occurred The **risk of dilution** increases when significant events occur because such events attract investors who are drawn to the possibility of **arbitrage opportunities**.

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**. ... This position applies equally to domestic securities.

Whether a particular event is a significant event depends on whether the event will affect the value of a fund's portfolio securities. Such **events may relate to a single issuer or to an entire market sector**. **Moreover, significant fluctuations in domestic or foreign markets may constitute a significant event**.

\Funds should regularly evaluate whether their pricing methodologies continue to result in values that they might reasonably expect to receive upon a current sale.... a fund board generally would not be acting in good faith if, for example, the board knows or has reason to believe that its fair value determination does not reflect the amount that the fund might reasonably expect to receive for the security upon its current sale. In addition, a fund board generally would not be acting in good faith if it acts with reckless disregard

securities for which market quotations are readily available. In such circumstances, **funds are not permitted to ignore** these **quotations** and fair value price the securities

Rule 38a-1

Adoption of Rule 38a-1 – 12/17/03 – Boards need to adopt policies and procedures reasonably designed to prevent violations of the federal securities laws:

- If an event affecting the value of the portfolio securities occurs *after* the foreign market closes but *before* the fund prices its shares, the foreign market closing price for the portfolio security will not reflect the correct current value of those securities when the fund prices its shares
- funds must fair value their portfolio securities whenever market quotations become **unreliable** .(citing the 1999 and 2001 letters).
- Fn 43: in addition to monitoring for events that may necessitate fair value pricing, funds must pay attention to circumstances that would suggest the need for using fair value pricing.
- **Software** developed by vendors is today available to assist funds to determine the fair value of portfolio securities.

Disclosure Regarding Market Timing

N-1A amendment in 2004 regarding **Disclosure Regarding Market Timing** require funds to disclose both the circumstances under which they will use fair value pricing and the effects of using fair value pricing

if a fund invests primarily in securities that are traded on overseas markets, we would expect a fuller discussion of the circumstances under which the fund will use fair value pricing, such as specific events occurring after the close of the overseas exchange that would cause the fund to use fair value pricing

[funds of funds can refer to underlying prospectuses]

Valuation Issues for Investment Companies

Parnassus Investments – 9/3/1998

Affiliated director and adviser deemed to have violated §§13(a)(3) and 21(a) for not adhering to stated policies – by lending money to a bankrupt entity in which the fund had invested, in exchange for a convertible debenture that was valued as converted after delisting at last exchange price, higher than the pink sheet value and not discounted for restricted stock.

Independent **directors aided and abetted the fund's 22c-1 violation**

Sanction – cease and desist

Valuation Issues for Investment Companies

Heartland Group (Hammes et al., 12/11/2003) settled for **cease and desist** order

Bonds were priced by FT Interactive Data. Fund developed liquidity problems because of the illiquidity of the underlying bonds. Bonds were transferred to the State of Wisconsin investment board at prices approximately 50% below the value at which the Funds had been carrying those bonds in the normal course. Moreover, the transaction was only completed because Heartland Advisors' President, William Nasgovitz, personally guaranteed it, and because it included an agreement whereby SWIB could "put" the bonds back to Heartland Holdings, Inc., with a guaranteed annual return of 20%. The Division of Investment Management indicated that it would oppose any application for any order that would permit the Funds to suspend redemptions. As a result, the Pricing Committee purported to price the bonds at fair value, determined to be a uniform haircut to the prices suggested by the portfolio managers. Both before and after October 13, 2000, the Funds redeemed millions of shares in the Short Duration and High Yield Funds at incorrect NAVs.

Directors failed adequately to assure that bonds were priced at "fair value" or adequately to monitor and assure the bonds' liquidity. While mutual fund directors are permitted to delegate some responsibility for pricing a fund's securities to a separate committee, each director retains responsibility to be involved in the valuation process and may not passively rely on securities valuations provided by such a committee. Directors violated **1933 Act §17(a)**. Directors did not take adequate action to ensure that their requests to management were satisfied. They were a cause of the Funds' Rule **22c-1** violations.



Valuation Issues for Investment Companies



Attempts at Guidance

ICI Fair Valuation Series 2005 & 2006, updating white papers 1998 and 2001

Mutual Fund Directors Forum – Practical Guidance 6/2012

Division of Investment Management – Norm Champ speech 12/2012: “additional guidance in this area would be useful because much has changed”



Enforcement Actions

2011 – one settled action

2012 – six settlements

UBS Global Asset Management (Americas) Inc. 1/17/2012 - \$300,000

“UBSGAM failed to cause certain fixed-income securities in the portfolios of the Funds to be valued in accordance with the Funds’ fair valuation procedures”

Yorkville Advisors LLC – 10/17/2012 –

hedge fund adviser- based on enforcement unit-DEIRA Aberrational Performance Inquiry

Enforcement Division Asset Management Unit press release: the unit “continues to prioritize asset valuation investigations”

Valuation Issues for Investment Companies

Enforcement Actions – common elements

- • Fixed-income securities were valued at **fair value rather than based on current market prices** available on the fair value date.
- • Interest **paid in-kind** increased the carrying value of distressed debt where it was unlikely that principal and interest would be recovered.
- • The value of an investment's underlying **collateral was misrepresented**.
- • Asset-backed securities and structured products were valued by **models that did adequately incorporate market-based data**.
- • Illiquid securities were valued by **consultants that relied on inputs from affiliated portfolio managers** that resulted in valuation overstatements.
- • Private equity investments were valued at cost without an adequate fair value analysis.
- • Investments that were valued using a discounted **cash flow model did not discount future estimated proceeds** to present value.
- • Valuations of debt securities did not take into account the effect of major corporate events, including a bankruptcy proceeding.
- • Valuations were based on stale data that were not updated to reflect current market conditions.
- • Valuation methodologies for illiquid securities were misrepresented in marketing materials.

Valuation Issues for Investment Companies

Morgan Keegan (Kenneth Alderman et al.) 6/13/13 –

8 directors of fund that invested in 2007 in “below-investment grade debt securities for which market quotations were not readily available’ including subordinated tranches of various securitizations backed by sub-prime mortgages. Over 50% of \$4 billion of holdings required fair valuation.

Four of the directors were CPAs

Adviser and portfolio manager (James Kelsoe) settled charges for \$200 million in July 2011 based on misleading conduct, failure to supervise, inadequate procedures

Charges director violations of:

Rule 38a-1 – compliance policies

Rule 22c-1 – purchases and sales at NAV

Rule 30a-3(a) – internal controls over financial reporting

Registration statement false or misleading statements

Settled on 38a-1 – unsuitable valuation policies (just repeating ASR guidance)

Morgan Keegan (continued)

The Directors **did not specify a fair valuation methodology** pursuant to which the securities were to be fair valued. **Nor did they continuously review** how **each issue** of security in the Funds' portfolios were being valued. The Directors delegated their responsibility to determine fair value to the Valuation Committee of the investment adviser to the Funds, but **did not provide any meaningful substantive guidance** on how those determinations should be made. In addition, they **did not learn how fair values were actually being determined**. They received only limited information on the factors considered in making fair value determinations and almost no information explaining why fair values were assigned to specific portfolio securities.

Relation between Valuation and Liquidity

1986 Money Market Fund release and 1992 Guidelines to Form N-1A

An illiquid asset is any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment

Annual **Chief Accountant Letter** – 2/14/2001

we do **not** believe it is **appropriate to discount** or mark-up a readily available market price for an unrestricted security **solely because an investment company** holds a large quantity of the outstanding shares of an issuer or **holds an amount that is a significant portion of the security's average daily trading volume.**



Relation between Valuation and Liquidity

Open-End Fund Liquidity Risk Management Release

if a fund finds that it can only sell portfolio assets (or portions of a position in a particular asset) that are less liquid at prices that incorporate a significant discount from fair value, the discounted sale price can materially affect the fund's NAV

Therefore, proposes that funds maintain cash and assets that the fund believes are convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to the sale.

the person who classifies the liquidity of each portfolio position must determine—using information obtained after reasonable inquiry—the time period in which the fund would be able to sell the position, at a price that does not materially affect the value of that asset immediately prior to sale, and settle the sale



Relation between Valuation and Liquidity

the Commission has not addressed whether a fund might adjust its current NAV to lessen dilution of the value of a fund's outstanding securities, and the Commission's current valuation guidance could raise questions about making such a NAV adjustment



Use of Pricing Services - Money Market Fund releases

1986 – a mechanism must exist that can be reasonably expected to return the value of the instrument to par, *i.e.*, a variable interest rate, or that can reasonably be expected to keep the value of the instrument at par, *i.e.* a floating interest rate. Otherwise, the market-based value of the instrument could deviate

2014 - a fund may only use the amortized cost method to value a portfolio security with a remaining maturity of 60 days or less when it can reasonably conclude, at *each time* it makes a valuation determination, that the amortized cost value of the portfolio security is *approximately the same* as the fair value of the security as determined without the use of amortized cost valuation.

[Funds are] required to value, on a daily basis, the fund's portfolio securities using market-based factors and disclose the fund's share price (or shadow price) rounded to four decimal places on the fund's website.... [E]ach money market fund should have readily available market-based data to assist it

Use of Pricing Services – all funds - per the interpolated 6 pages of guidance

matrix pricing and similar pricing methods involve estimates and judgments—and thus may introduce some “noise”

pricing services employ a wide variety of pricing methodologies in arriving at the evaluated prices they provide, and the quality of those prices may vary widely.... Accordingly, we believe it is important to provide guidance to funds and their boards regarding reliance on pricing services.

evaluated prices provided by pricing services are not, by themselves, “readily available” market quotations or fair values “as determined in good faith by the board of directors” as required under the Investment Company Act.

“it is incumbent upon the [fund’s] Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered,”

Use of Pricing Services –

Before deciding to use evaluated prices from a pricing service to assist it in determining the fair values of a fund's portfolio securities, the fund's board of directors may want to consider the

- inputs,
- methods,
- models, and
- assumptions

used by the pricing service ...and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change

And ... assess, among other things:

the quality of the evaluated prices, and the

extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its net asset value



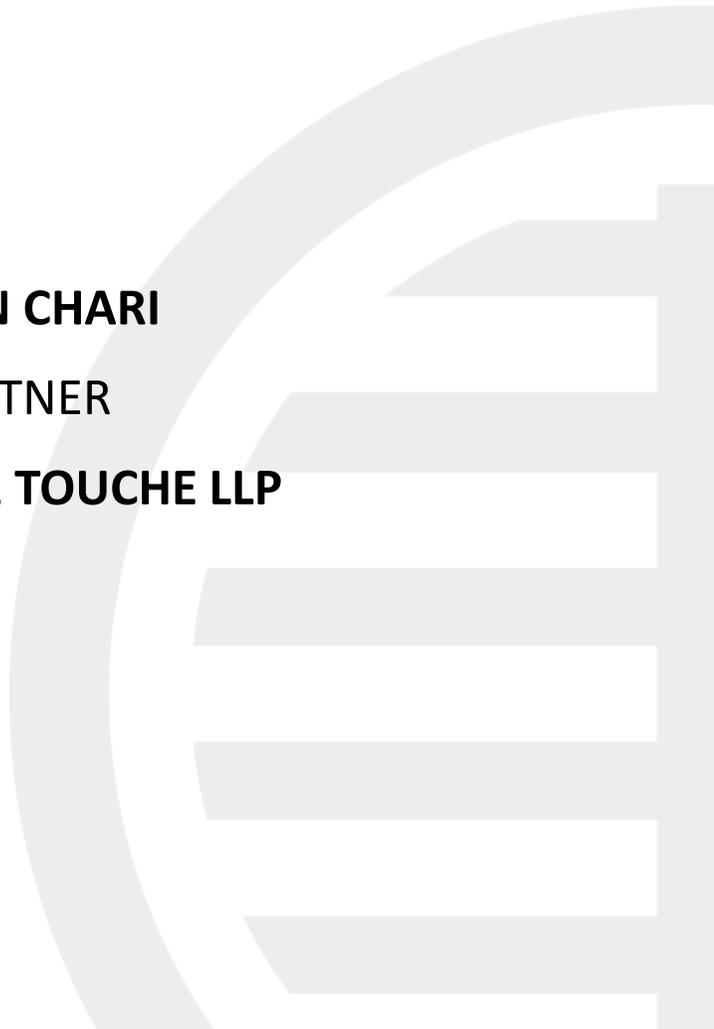
- **Director Guidance**
- Review with counsel and fund accounting and compliance personnel the fair value procedures to determine whether they provide meaningful guidance
- Approve the appointment of the committee or other persons who conduct fair valuation – assure no undue pressure from portfolio managers and that they do not sway the decision
- Obtain assurance that the fair value procedures reflect actual practices
- Outline a specific set of methodologies for different categories and sub-categories of securities and other investments
- When pricing services are used,
 - have presentations of inputs, methods, models and assumptions;
 - conduct annual review of changes and enhancements;
 - obtain assurance that a backtesting process exists and that results validate the firm's evaluation process

Valuation Issues for Investment Companies

- Director Guidance
- When broker prices are used, confirm that the brokers actually trade in the security and confirm reliability
- Include a process for identifying and reviewing security holdings with unchanged prices
- Include a process for backtesting valuations and for the reporting, correction and adjustment of valuations when necessary
- Ensure that board reports include appropriate explanations of the actual methodologies used and their application to the securities valued
- When issues are raised by the board, make sure there is follow-up
- During periods of market stress, pay special attention

Fair Valuation in Practice

RAJAN CHARI
PARTNER
DELOITTE & TOUCHE LLP



<http://www2.deloitte.com/us/en/pages/financial-services/articles/fair-value-pricing-survey-thirteenth-edition.html>



Voltaire
ADVISORS

Valuation, Liquidity & Derivatives

NEW YORK, 11TH FEBRUARY 2016



SEC Guidance on Use of Pricing Services

IAN BLANCE
MANAGING DIRECTOR
VOLTAIRE ADVISORS LLP

Why was the Guidance Required?

Money Market Fund Reform, Release No. 33-9616 – October 14 2014 (pp. 277-288)

“... we believe it is important to provide guidance to funds and their boards regarding reliance on pricing services.”

- ◆ Why? Reliance on, and influence of, a small market of third-party pricing vendors?
- ◆ Is this a problem?
- ◆ Guidance not just for Money Market Funds and did not change the rules
- ◆ More of an issue for more volatile, opaque or complex asset classes?
- ◆ Should we be more worried about Emerging Markets than Money Markets?

What Do Pricing Services Provide?

“We note that the evaluated prices provided by pricing services are not, by themselves, “readily available” market quotations or fair values “as determined in good faith by the board of directors” as required under the Investment Company Act.”

- ◆ Wide variety of methodologies are used and the ‘quality’ of prices may vary accordingly
- ◆ Fund board has a ‘non-delegable responsibility’ to determine fair value, and must:
 - a. satisfy themselves that ‘all appropriate factors’ impacting fair value have been taken into account and;
 - b. ‘continuously review’ the appropriateness of fair valuation methods
- ◆ Board may appoint others (such as their adviser or valuation committee) to assist in this process

What Are Fund Boards Obligations?

“Before deciding to use evaluated prices from a pricing service ..., the fund’s board of directors may want to consider the inputs, methods, models, and assumptions used by the pricing service ..., and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change.”

- ◆ ‘May want to consider ...’!?
- ◆ Does this mean that directors need to be evaluated pricing experts?
- ◆ Need to look specifically at:
 - Quality
 - Timing
 - Appropriateness to their fund

How Does This Work in Practice?

“... the staff believes that a fund’s board of directors’ may delegate to its appointee, subject to adequate oversight, specific responsibilities intended to assist it in implementing the fund’s valuation policies and procedures, including its due diligence of pricing services ...”

- ◆ ‘Subject to adequate oversight ...’ ?
- ◆ Day to day fair valuation typically delegated to investment adviser
- ◆ Escalation of fair value issues and problems to Valuation Committee
- ◆ Regular reporting of exceptions and over-rides to Board
- ◆ Due diligence usually performed by adviser

What Should Due Diligence Entail?

“... consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change.”

- ◆ Also specified that boards need to look at:
 - quality of the evaluated prices provided by the service
 - extent to which the service determines its evaluated prices as close as possible to the time as of which the fund calculates its NAV
 - appropriateness of using evaluated prices where they might not reflect what the fund could reasonably expect to obtain in a current sale under current market conditions

Current Due Diligence Efforts

- ◆ Efforts vary significantly from firm to firm ...
- ◆ Worst case scenario – ‘Set and forget’ and blind trust. Abdication rather than delegation of responsibilities
- ◆ Best case – regular conversations, questions, site visits and use of empirical data for analysis and deep dives
- ◆ Typical case – annual vendor questionnaire and conference call prior to contract renewal
- ◆ Underlying issues
 - Vendor relied on to provide information and explanations
 - Little considerations of alternatives outside incumbent vendor
 - Lack of specialist evaluation domain knowledge in adviser (esp. in complex or international asset classes)

Model Valuation Due Diligence

- ◆ **Independence** - Due diligence should be independent of both the fund, the adviser and the vendor
- ◆ **Detailed Process Review** - Analysis and review of the underlying procedures, methods, sources, documentation, etc. and these should be periodically revisited to ensure their continued appropriateness and effectiveness.
- ◆ **Source Review** - Line by line review of methods/sources per position (since there can be wide variations within asset classes - simply stating that X vendor is used for all fixed income pricing is not sufficient). Again, these should be periodically revisited to ensure their continued appropriateness and effectiveness
- ◆ **Metrics** - The position review should include detailed empirical data on key metrics such as vendor overrides, price challenges, challenge results, stale prices, tolerance breaks, comparisons of valuations with trades, alternative prices (if available), etc.
- ◆ **On Site Due Diligence** - If a vendor is used for pricing, then there should be regular and detailed due diligence of their operations, processes, procedures, etc.

Due Diligence in the New Regulatory Regime

KARL MACKELBURG

GLOBAL HEAD OF SOVEREIGN,
CORPORATE & MUNICIPAL
EVALUATIONS

THOMSON REUTERS



REUTERS/Ilya Naymushin

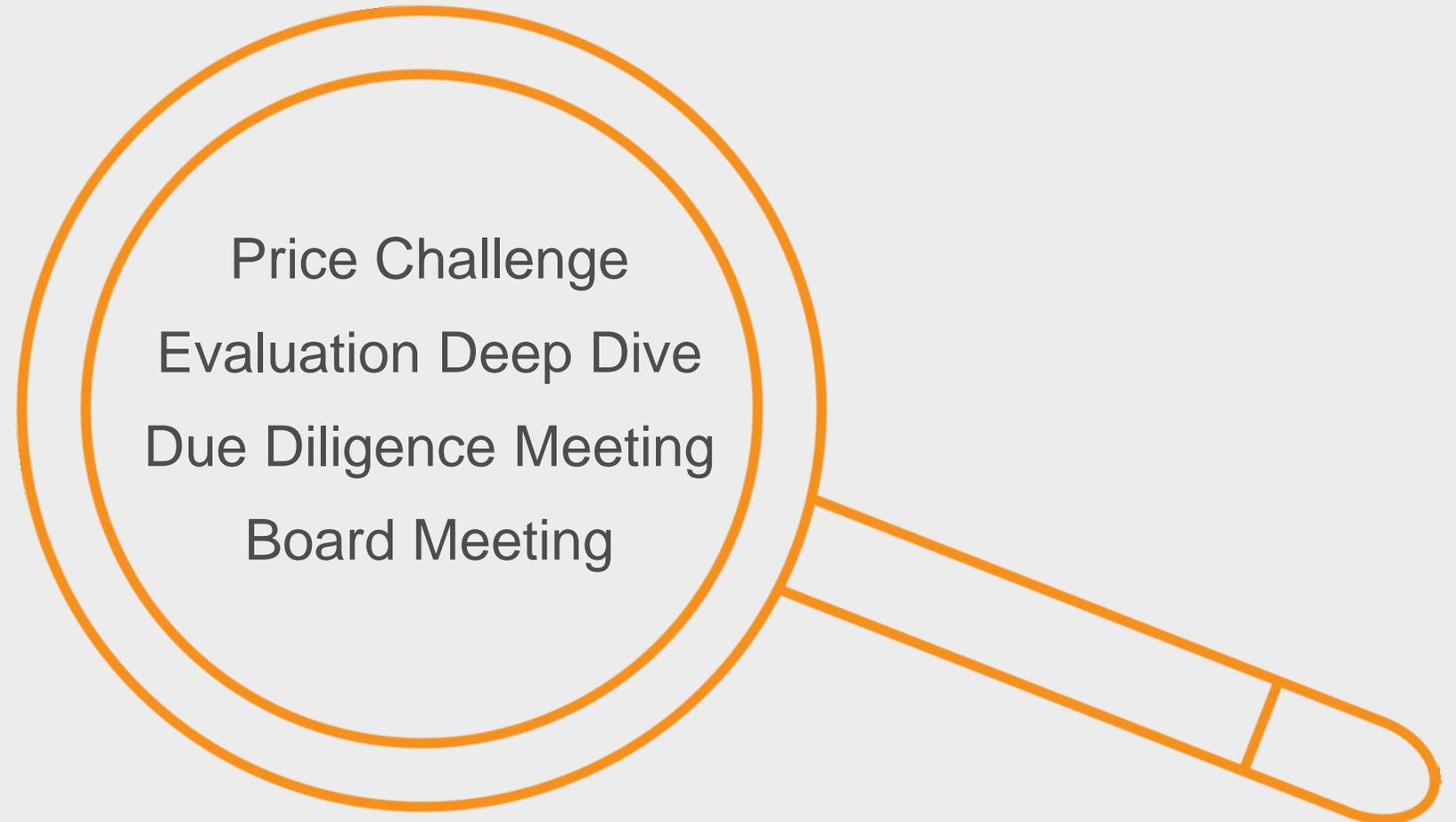
DUE DILIGENCE IN THE NEW REGULATORY REGIME

KARL MACKELBURG - GLOBAL HEAD OF SOVEREIGN, CORPORATE, AND MUNICIPAL EVALUATIONS

FEBRUARY 11, 2016



TYPES OF DUE DILIGENCE



PRICE CHALLENGE



- Oldest Form of Due Diligence
- Most Voluminous
- **Traditional:** Driven by portfolio manager based upon dealer input. Fund accountants would question tolerance breaks and unchanged prices.
- **Current:** Driven by valuation departments based dealer input and vendor to vendor differences

2015	Quantity	Confirmed	Changed	Changed ▲	Changed ▼
January	14,658	83.2%	16.5%	50.1%	46.3%
February	14,614	83.0%	16.8%	58.8%	40.9%
March	12,605	80.2%	19.6%	50.5%	49.3%
April	12,760	85.6%	14.3%	59.1%	38.8%
May	15,315	87.0%	12.9%	57.9%	42.0%
June	14,712	84.2%	15.8%	48.3%	51.7%
July	14,279	83.4%	16.5%	50.6%	49.4%
August	14,110	85.2%	14.7%	38.6%	61.4%
September	14,187	86.1%	13.9%	48.8%	51.2%
October	14,389	88.2%	11.8%	52.8%	47.1%
November	10,697	85.5%	14.5%	51.8%	48.2%
December	15,727	86.1%	13.9%	40.4%	59.6%
Total	168,053	142,585	25,299	51%	49%

EVALUATION DEEP DIVE



DATASCOPE SELECT 02364WAX3 GO Recent john daly Help Sign Out

AMXL 5.000 10/16/19 (02364WAX3) 9008283 (HDCP-NWSWEB02)

Summary

Pricing and Analytics

Price History

Ratings

Bond Schedule

Legal Entity

Cross Reference

Reload

Add to Lists

Submit Challenge

Print

Chat with TRPS

Valuation	
Contributor	EJV
Trade Date	02/08/2016
Close Price	108.654
Universal Close Price Date	02/08/2016
Universal Close Price	108.634
Accrued Interest	1.597
Currency Code	USD
Quoted Clean Indicator	Yes
Maturity Corp OTR Spread	170.000
Maturity Corp Modified Duration	3.330
Maturity Corp Convexity	0.134
Maturity Corp DV01	0.037
Maturity Average Life	3.681
Option Adjusted Yield	2.522
Option Adjusted Spread	159.355
Option Adjusted Duration	3.326
Option Adjusted Convexity	0.134
Option Adjusted DV01	0.037
Worst Standard Yield	2.522
Worst Corporate Yield	2.522

Pricing Recipe	
Pricing Method	YS
Valuation	EJV
Pricing Method Value	170.000
Benchmark	Point 3Y
Redemption Date	10/16/2019
Redemption Event	MAT
Redemption Type	MAT
Benchmark Type	3YR
Benchmark Term	3.681
Benchmark Value	0.822

Thomson Reuters Premium Pricing						
Region	Time	Trade Date	Bid Price	Ask Price	Mid Price	Bid Ask Spread
US	15:00 EST/EDT	02/08/2016	108.654	109.154	108.904	0.500
US	16:00 EST/EDT	02/08/2016	108.634	109.134	108.884	0.500

Tolerance Comments	
Tolerance Report Date	--
Tolerance Percent Price Change	--
Tolerance Comments	--
Evaluator Telephone	--
Evaluator Group Telephone	--

Transparency Fields	
Comparable Security Observed	y
Broker Quotes Observed	Multiple
Direct Trace Trades Observed	2
Indirect Trace Trade Observed	--
Issuer Movement Observed	y
Number of Contributed Prices	10
Evaluator Name	Fernando Gamio
Cohort	--
MBS Payup	--
MBS Spot Adjustment	--

Unchanged Fields	
Unchanged - Day Count	--
Unchanged - Evaluator Commentary	--
Unchanged - Evaluator Name	--
Unchanged - Evaluator Telephone	--
Unchanged - Evaluator Group Telephone Phone	--

Evaluator Commentary	

Clients are requesting more information on these fields.

DUE DILIGENCE MEETINGS



Thomson Reuters Pricing performed over 200 due diligence meetings in 2015.

Drivers of Due Diligence

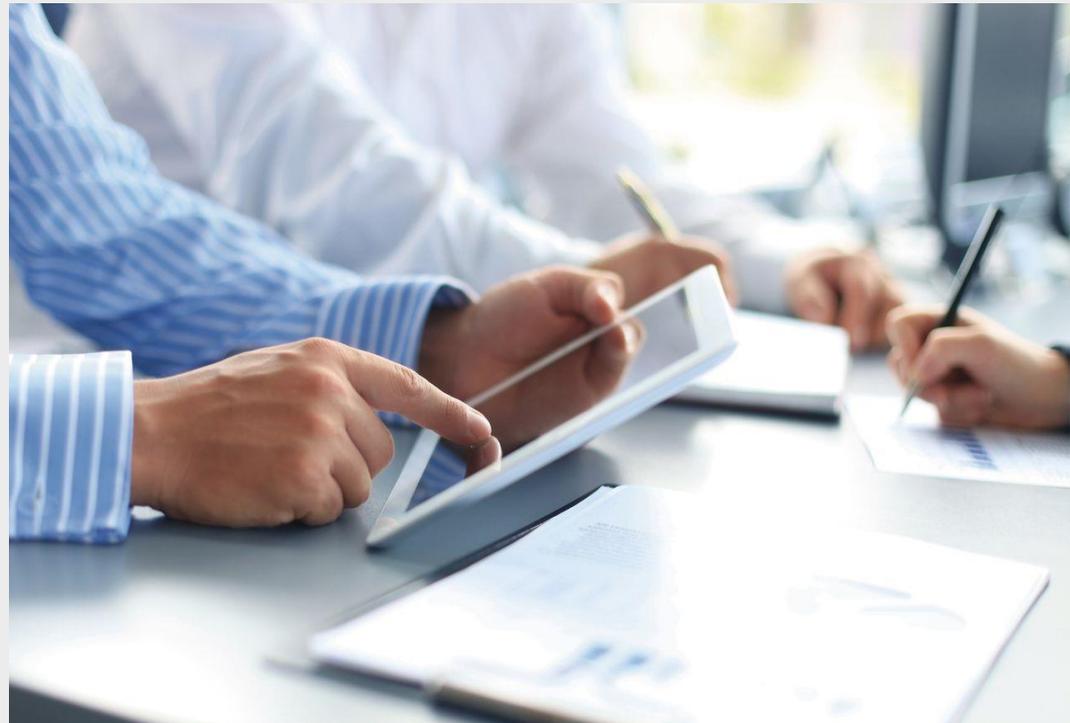
- Regulators
- Board of Directors
- Internal compliance
- Relationship building (face to face)
- Clients want to be proactive, rather than reactive.

Due Diligence Agenda Items

- Organizational Overview
- Staffing
- Asset Class Methodologies
- Deep Dives
- Sit-downs with Evaluation Teams
- Cyber Security
- Business Continuity Plan
- Deep Dives
- Compliance Program / Internal Audit – SOC1 Type II

BOARD MEETINGS

- Conducted at client site.
- Attended by Board of Directors and Business Owners.
- Previously 5 minutes – now up to an hour.
- Previously high level only – now involves due diligence discussion.
- Agenda focused on quality control, business continuity, and conflicts of interest.



FREQUENTLY ASKED QUESTIONS



- *Describe the legal, organizational, and reporting structure of the company.*
- *How is the evaluation team structured? How do you ensure adequate coverage? Is there a formal training program in place for newly hired evaluators?*
- *How many evaluators are there? Has this increased or decreased since last year? What is their experience level? What is the average employment tenure of your pricing evaluators?*
- ***Please provide your current/upcoming initiatives.***
- *What trends are you seeing the industry and how are you reacting to those trends?*
- ***What are your policies and procedures for thinly traded / illiquid securities?***
- *Please list statistics on number of securities priced.*
- ***Do you have a SAS 70 and/or SSAE16? Can we get a copy?***
- *Describe the price challenge process, including controls or monitoring of the communication between client and vendor.*
- *Please provide details regarding your company's continuity of business plan and any disaster recovery testing.*

NOTEWORTHY QUESTIONS



- *Do you own any patents on the pricing models used?*
- ***Does the broker express disclaimers or limitations on the use of the quote such that an auditor may be unable or unwilling to rely on the confirmation?***
- ***Is there a materiality threshold that must be met in order for a price challenge to be acted upon?***
- *What type of disasters or significant disruptions have you planned for?*
- *Does your firm have plans in place that deal with high absenteeism events, such as a pandemic?*
- *What insurance coverage does TRPS hold? Provide a summary of your firm's professional liability insurance coverage. Are employees bonded? To what level?*

BEST PRACTICES IN DUE DILIGENCE



- **Who should attend?** Senior staff, actual users, portfolio managers, compliance?
- **Morning meetings:** best evaluator access
- **Terms and Conditions:** forgotten stepchild
- **Deep Dives:** sample from each asset class to assess asset class methodology and staff
- **Questionnaire:** should be reviewed in advance by client



Panel Discussion

LATEST GUIDANCE ON MUTUAL FUND VALUATION

IAN BLANCE – VOLTAIRE ADVISORS
(MODERATOR)

RON FEIMAN – KRAMER LEVIN

CHRIS FRANZEK – DUFF & PHELPS

KARL MACKELBURG – THOMSON
REUTERS

Panel Questions

1. Does the panel consider that the updated valuation guidance in Release 33-9616 required mutual fund boards, officers or their advisers to change their policies and procedures?
2. The guidance restated that evaluated prices do not represent either 'readily available market quotations' or 'fair value as determined in good faith'. Is this fair? What, then, in the panels opinion, do evaluated prices represent?
3. Does the panel agree that the use of external pricing services might make a fund unduly reliant on a small number of such firms, or that they might exercise an undue influence on the NAV? How might this be avoided?
4. What does the panel think of the industry feedback that the use of third party pricing services might increase operational complexity and risk? If so, why? And if not, why not?
5. The new guidance reiterates the need for fund boards, and those they appoint to assist them in their fair value responsibilities, perform regular due diligence on the pricing services they employ. What does the panel think that this should entail?



Voltaire
ADVISORS

Valuation, Liquidity & Derivatives

NEW YORK, 11TH FEBRUARY 2016

Afternoon Agenda

- ◆ 1330 Keynote : Inside the SEC – Norm Champ, Kirkland & Ellis and Former Director of Investment Management Division, SEC
- ◆ 1400 New Liquidity Management Regulation – Nathan Greene, Shearman & Sterling
- ◆ 1430 Liquidity Management & Valuation – Chris Franzek, Duff & Phelps
- ◆ 1500 Panel Discussion – Impact of Liquidity Management Rules
 - Ian Blance | Chris Franzek | Nathan Greene | Varun Pawar
- ◆ 1530 Coffee
- ◆ 1600 New SEC Derivative Management Proposals – Jay Baris, Morrison & Foerster
- ◆ 1630 Panel Discussion – Latest Guidance on Mutual Fund Valuation
 - Ian Blance | Jay Baris | Kent Knudson
- ◆ 1700 Close of Workshop

KEYNOTE

Inside the SEC: SEC
Regulatory Prospects
for 2016

NORM CHAMP

PARTNER

KIRKLAND & ELLIS LLP

FORMER DIRECTOR OF
INVESTMENT MANAGEMENT
DIVISION, SEC

SEC REGULATORY PROSPECTS 2016

VOLTAIRE ADVISORS

VALUATION, LIQUIDITY AND DERIVATIVES CONFERENCE

FEBRUARY 11, 2016

New York, NY

Norm Champ, Partner, Kirkland & Ellis LLP
Former Director, SEC Division of Investment Management

Email: norm.champ@kirkland.com

Twitter: [@NormBChamp](https://twitter.com/NormBChamp)

Website: normchamp.com

Overview

- Current Activities
- Enforcement Issues
- Examination Issues
- IM Rulemaking
- Other Hot Topics
- What to do?

Current Activities

- New Partner in funds practice at Kirkland & Ellis LLP in New York.
- Working with prospective publishers of Going Public, a book about my experiences at the SEC
- Teaching Investment Management Law at Harvard Law School in Fall 2016

Enforcement Issues - CCO Cases

- Role of Compliance

- How has compliance been impacted by CCO enforcement actions?
 - Supervision vs. Oversight
 - *Blackrock*
 - *SFX Financial*

- Discuss related issues raised in the recent release from OCIE, *Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers*

- What is the message here for compliance officers/directors and others?

- Importance for Valuation

- Morgan Keegan case against Fund Directors

- Reaction

- The Role of CCOs Must Be Supported (Comm. Aguilar)
- Statement on Recent SEC Settlements (Comm. Gallagher)

Examination Issues

- **Examinations**
 - Risk-based Program
 - OCIE Priorities
 - Sweep Examinations
 - Collaboration with Enforcement
- **Shift of BD examiners to IA/IC**
- **‘Distribution in Guise’ - First Case**
 - First Eagle
 - Sub-TA fees found to be distribution

IM Rulemaking

- Rulemaking
 - Form ADV/Form PF (May)
 - Liquidity Risk Management (September)
 - Derivatives (December)
- Still to Come:
 - Stress Tests
 - Adviser Transition Plans
- Will Liquidity be Adopted in 2016?
- Will Third Party Exams Be Proposed?

Liquidity

- Risk Management Program
- Swing Pricing
- Buckets

Third Party Exams

- Testimony by IM Director David Grim indicates staff is pursuing a proposal to require IAs to hire third party examiners.
- Previous “outsourcing” to NRSROs and proxy advisory firms did not go well.
- OCIE reallocation of resources

Hot Topics – Valuation Guidance

- SEC Money Market Fund Release Set Forth Valuation Guidance
- Why there?

Hot Topics - DOL Fiduciary Rule

- Rule advanced to OMB in January
 - Will DOL issue it before election?
 - Impact
- Why has SEC not acted on harmonization?

Hot Topics - FSOC

- FSOC Principals Met in January
- Readout Indicates FSOC still Studying Investment Management Activities

Hot Topics - Cybersecurity

- SEC Roundtable – March 2014
- Exam Sweep Results – February 2015
- Latest Guidance – April and September 2015
- OCIE Exam Priority for 2016

Hot Topics - Alternative Mutual Funds

- Rapid Growth in 2013 and 2014
- Flows slowed in 2015
- Issues to Consider
 - Valuation
 - Disclosure
 - Liquidity
 - Leverage
 - Compliance
- Impact of IM Proposals

What to do? - Relationship with Regulators

- **Developing Relationships with Regulators**
 - Meeting Regulators when things are quiet
 - Providing Input and Data on Rule Making
- **Handling Examinations and Investigations**

New Liquidity Risk Management Proposals

NATHAN GREENE

CO-LEADER, ASSET MANAGEMENT
GROUP

SHEARMAN & STERLING LLP

Proposed SEC Liquidity Rules for Mutual Funds

Nathan J. Greene

ngreene@shearman.com

§February 11, 2016

*§Presentation to the Voltaire Valuation, Liquidity
and Derivatives Workshop*



Contents

Highlights	
Industry reaction	
Assessment and periodic review of liquidity risk	
Three-day liquid asset minimum	
Position-level liquidity classifications	
Administration of the program and role of the board	
Disclosure and reporting	
Optional swing pricing	
Compliance dates	
Resources	1

Highlights



Highlights

Liquidity risk management programs

- Assessment and periodic review of liquidity risk
- Fund-specific “three-day liquid asset minimums” (TDLAM or 3DLAM)
- Position-level liquidity classifications (“bucketing”)

Disclosure

- Increased disclosure around redemption policies, including specifying typical payment periods
- Public Form N-PORT information to include position-level liquidity classifications

Optional “swing pricing”

- Mutual funds (but not money market funds or ETFs) would have option of using swing pricing
- “Swing pricing” = adjusted NAV that passes on to purchasing or redeeming shareholders more of the costs from fund trading activity prompted by purchases or redemptions

Who’s covered?

- Every mutual fund and open-end ETF (generally except money market funds and UITs)
- Closed-end funds not covered

Industry reaction

Industry reaction

Liquidity risk cannot be mandated away

Liquidity risk is a basic element of investing

Prescriptive liquidity restrictions are not necessary for investor protection, not necessarily in the best of interest of shareholders, nor have we found it part of the Commission's statutory mandate

Maybe some funds need special scrutiny (but don't regulate everybody)

Certain investment strategies may be inherently inappropriate for the open-end fund structure. Such funds, which may include those with concentrated distressed debt portfolios and certain alternative funds, are likely more suitable as closed-end funds, interval funds or private funds

Flexible risk management programs – Thumbs up

Strongly support the proposal to require each fund to adopt and implement a liquidity risk management program

Industry reaction

Liquidity classifications – Thumbs down

Excessively granular and fundamentally at odds with the imprecise nature of liquidity judgments and estimates

Novel and untested

Concept of converting the asset to cash “at a price that does not materially affect the value of that asset immediately prior to sale” is simply too subjective

TDLAM – Thumbs down

Not sufficiently dynamic to respond to changing market conditions

Would unnecessarily constrain a fund’s ability to employ its investment strategy

Public reporting – Thumbs down

Funds that are more conservative in assigning liquidity levels, and thus are in fact less risky, will appear to be less liquid, and thus more risky. Funds that more aggressively classify liquidity will appear more liquid

Assessments of liquidity on a position-by-position basis are necessarily stale as soon as they are made

Industry reaction

Swing pricing – Maybe

Partial swing pricing may help in mitigating potential dilution of fund shareholders. We believe swing pricing (a) must be mandatory in order to have funds use it, (b) funds must receive investor flow information in sufficient time for swing pricing to be operationally feasible, and (c) there must be a safe harbor for good faith decisions and actions that shield funds from potential liability

Although we support swing pricing, we believe that the Commission should delay effectiveness until industry structural issues are addressed

Industry reaction

A “safe harbor” would be nice

*The concept of converting the asset to cash “at a price that does not materially affect the value of that asset immediately prior to sale” is simply too subjective. Markets are volatile and it will be up to funds to interpret what “material” should mean in this context. For these reasons, at a minimum, we believe the proposal should provide that funds, investment advisers and boards will **not be liable for good faith liquidity classification** determinations that subsequently turn out to differ from actual outcomes*

More time would help too

The compliance date should be 30 months after the effective date for all funds

Assessment and periodic review of liquidity risk



Assessment and periodic review

The proposed rule would require each fund to assess its liquidity risk, taking at least the following factors into account:

- Short-term and long-term cash flow projections, taking into account the following considerations:
 - Size, frequency and volatility of historical purchases and redemptions of fund shares during normal and stressed periods
 - The fund's redemption policies
 - The fund's shareholder ownership concentration
 - The fund's distribution channels; and
 - The degree of certainty associated with the fund's short-term and long-term cash flow projections
- The fund's investment strategy and liquidity of portfolio assets
- Use of borrowings and derivatives for investment purposes
- Holdings of cash and cash equivalents, as well as borrowing arrangements and other funding sources.

Assessment and periodic review

Liquidity risk is then periodically reviewed

- Reviews to take into account the factors required for the initial assessment
- Beyond the factors, no prescribed review procedures and no specific developments that a fund should consider as part of its review
- Required semi-annual review of TDLAM and an annual board reporting requirement
- But no other suggestions of required review periods, except that changes in circumstances may require more frequent reviews than planned (frequency of assessment can't be rigid)

Three-day liquid asset minimum

The table contains 12 rows of text that has been blurred for redaction. The text is organized into columns, but the specific content is illegible.

Three-day liquid asset minimum

Each fund would set and maintain a fund-specific TDLAM

- TDLAM should take into account the liquidity risk factors described above (fund flows, investment strategy, etc.)
- Fund board would be required to approve the TDLAM, including changes over time
- Review the TDLAM no less frequently than semiannually
- Written record of how TDLAM was determined, including an assessment of each of the liquidity risk factors (see above)
- Written reports to fund board concerning the adequacy of the fund's liquidity risk management program, including the TDLAM
 - No forced sales to comply with the TDLAM; instead a fund would not acquire a less liquid asset if, immediately after acquisition, the fund would be out of compliance with the TDLAM

Position-level liquidity classifications



Position-level liquidity classifications

A fund would classify the liquidity of each of the fund's positions in a portfolio asset (or portions of a position in a particular asset) and review the classifications on an ongoing basis

- Would consider the number of days within which a fund's position (or portions of the position) would be convertible to cash at a price that does not materially affect the value of that asset immediately prior to sale
- The SEC intends that classification be on a share by share basis
- For example: if a fund holds a block of shares, might determine some shares (e.g., the first 50%) are convertible to cash in one period with the remainder convertible to cash in a longer period

Position-level liquidity classifications

Six liquidity categories

Each position (again, share-by-share basis) would be bucketed as follows:

- Convertible to cash within 1 business day
- Convertible to cash within 2-3 business days
- Convertible to cash within 4-7 calendar days
- Convertible to cash within 8-15 calendar days
- Convertible to cash within 16-30 calendar days
- Convertible to cash in more than 30 calendar days

Position-level liquidity classifications

When classifying a position's liquidity, would **take at least the following factors into account:**

- Existence of an active market, including whether listed on an exchange, as well as number, diversity and quality of market participants
- Frequency of trades or quotes and average daily trading volume (regardless of whether the asset is a security traded on an exchange)
- Volatility of trading prices
- Bid-ask spreads for the asset
- Whether the asset has a relatively standardized and simple structure
- For fixed income securities, maturity and date of issue
- Restrictions on trading and limitations on transfer
- Size of position relative to average daily trading volume and number of units outstanding
- Relationship of the asset to another portfolio asset

Administration of the program and role of the board

Administration of the program and role of the board

- Would require initial approval of the written liquidity risk management program from the fund board, including a majority of independent directors.
- Board approval to include specific approval of the fund's TDLAM
- Would require approval of any material changes to the fund's liquidity risk management program, including changes to the TDLAM, from the fund board, including a majority of independent directors
- Designation of persons responsible for administering the liquidity risk management program
- Designation must be approved by the fund board; designee may be the fund's investment adviser or officers (who, for this purpose, may not be solely portfolio managers of the fund)
- Management would prepare, and the fund board would review, a written annual report on the adequacy of the fund's liquidity risk management program, including the TDLAM, and the effectiveness of its implementation

Disclosure and reporting



Disclosure and reporting

Proposed amendments to Form N-1A

- Would require a fund to disclose in its prospectus the number of days in which the fund will pay redemption proceeds (If differs by channel, would specify by channel)
- Would disclose the methods used to meet redemption requests, specifying differences that might be applied in normal versus stressed markets
- For a fund that uses swing pricing, would explain circumstances under which swing pricing would be used as well as the effects of using swing pricing

Proposed amendments to Form N-PORT (new form, not yet in force)

- Would disclose the liquidity classification of each of the fund's positions using the six liquidity categories discussed above
- Would disclose the fund's TDLAM

Proposed amendments to Form N-CEN (new form, not yet in force)

- New questions and exhibits regarding lines of credit, interfund lending, interfund borrowing and swing pricing

Optional swing pricing



Optional swing pricing

Presented by the SEC as an option – a tool that would be available to funds

- “Swing pricing” refers to a process for adjusting a fund’s NAV to effectively pass on the market impact costs, dealer spreads, and transaction fees and charges stemming from net capital activity (i.e., flows into or out of the fund) to the shareholders associated with that activity
- Pricing adjustments are intended to protect other shareholders from dilution arising from these trading costs
- In operation, requires:
 - A swing threshold – triggering level of purchases or redemptions that activates swing pricing (and thus the ability to predict flows)
 - A swing factor – variable amount by which NAV swings up on inflows or down on outflows (and thus the ability to estimate trading costs)

Optional swing pricing

Administration of swing pricing

- A fund would be required to review written swing pricing policies and procedures at least annually, with material changes subject to fund board approval
- Fund board would designate the fund's adviser or officers responsible for administering the policies and procedures
- Recordkeeping requirements relating to swing pricing and related NAV adjustments

Compliance dates

Liquidity Risk Management Program

- For larger entities (funds that together with other investment companies in the same “group of related investment companies” have net assets of \$1B or more as of most recent fiscal year-end) proposed compliance date **18 months** after the effective date
- For smaller entities, **30 months** after the effective date

Swing Pricing

- As swing pricing would be optional, a compliance period would not be necessary.
- A fund would be able to rely on the rule, if adopted, as soon as can comply with rule requirements and related records, financial reporting and prospectus disclosure

Amendments to Form N-1A

- Initial registration statements, and all post-effective amendments that are annual updates, would have to comply if filed **six months** or more after the effective date

Amendments to Form N-PORT

- For larger entities (defined above), compliance date would be **18 months** after the effective date
- For smaller entities, **30 months** after the effective date

Resources

- **SEC Proposal:** <http://www.sec.gov/rules/proposed/2015/33-9922.pdf>
- **Comment Letters on File:** <http://www.sec.gov/comments/s7-16-15/s71615.shtml>
- **Shearman & Sterling Friends and Clients Note:**
<http://www.shearman.com/en/newsinsights/publications/2015/10/liquidity-of-mutual-fund-portfolios>

Liquidity Management Rules for Mutual Funds and their Impact on Valuation



CHRIS FRANZEK
MANAGING DIRECTOR
DUFF & PHELPS

Will New SEC Liquidity Management Rules for
Mutual Funds and ETFs have Valuation
Implications?

February 11, 2016

Agenda

- Background: Why new Rules
- Overview of Proposed New Rules
- Disclosure Buckets
- Valuation Tension
- Observations & Questions

SEC's Mission

- Protect Investors
- Ensure securities markets operate fair and orderly
- Help businesses raise capital

Chair Mary Jo White:

A critical part of our mission at the SEC is to build investor confidence by making sure that market players like stock brokers or investment advisors are following the rules and treating investors fairly.

Proposed New Rules

Rules for Mutual Funds and Exchange-Traded Funds (ETFs):

- Required liquidity risk management programs
- Enhanced fund liquidity & redemption disclosure
- Framework for using “swing pricing”

Chair Mary Jo White:

Promoting stronger liquidity risk management is essential to protecting the interests of the millions of Americans who invest in mutual funds and exchange-traded funds. These significant reforms will require funds to better manage their liquidity risks, give them new tools to meet that requirement, and enhance the Commission’s oversight.

Elements of a Fund's Liquidity Risk Management Program

- Classification of the liquidity of fund assets based on the amount of time required to convert the asset to cash without market impact
- Assessment, periodic review & management of liquidity risk
- Establish a three-day liquid asset minimum
- Fund's Board approval and review requirements

Codification of 15 percent limit on illiquid assets

Liquidity Risk / Three Day Asset Minimum

Liquidity Risk defined:

The risk that a fund could not meet redemption requests that are expected under normal conditions and under stressed conditions, without materially affecting the fund's NAV.

Three-Day Liquid Asset Minimum:

Percentage of a fund's net assets that must be invested in cash and assets that are convertible to cash within three business days at a price that does not materially affect the value of assets immediately prior to sale.

Disclosure Buckets

Each asset position or portion of a position classified based on the time required to **convert to cash, without affecting value immediately prior to sale:**

1 BUSINESS DAY

2-3
BUSINESS
DAYS

4-7
CALENDAR
DAYS

8-15
CALENDAR
DAYS

16-30
CALENDAR DAYS

More than 30
CALENDAR DAYS

15% Limit / Swing Pricing

15% limit on illiquid assets; Illiquid asset defined as:

An asset that cannot be sold within 7 days at approximately its stated value (not converted to cash)

Swing Pricing Choice:

A fund may reflect in its NAV a specified amount:

the swing factor,

Once the level of net purchases or redemptions from the fund exceeds a specified percentage of the fund's NAV:

the swing threshold.

Valuation Tension

ASC Topic 820:

- Actively traded assets (sufficient volume and frequency to determine a price—generally exchange traded)
- By rule valued at $P * Q$
- No blockage discount allowed

Proposed New Rules:

- Disclosure buckets driven by time to convert to cash
- Large holdings likely split between buckets

SEC historical viewpoint:

- No blockage discount

Should FASB revisit $P*Q$?:

Competing Definitions?

Overlapping classifications could create confusion

- Disclosure buckets—Time to Convert To Cash
- Liquid/Illiquid—Sold within 7 days
- Financial Reporting—Level 1, 2, 3 Valuation Inputs

Example—Unicorn

- Classified as Level 3; Valued using unobservable inputs
- Liquid—Could be sold within 7 days
- <30 days—May require time for proceeds to be received

Example—Foreign Exchange Traded Security

- Classified as Level 1; Valued at $P \cdot Q$
- Liquid—Could be sold within 7 days
- <30 days—May require time for proceeds to be received

Level 3 Valuations

Historically most Mutual Fund's invested in assets classified as level 1 or level 2 (valued using observable inputs)

Increasingly investing in “private” investments resulting in considerations:

- Valued using level 3 inputs (does the Fund have a framework for valuation)
- Impacts 15% illiquid rule
- Impacts disclosure buckets

Open Questions

- Given the liquidity judgments, will disclosures between funds be comparable?
- Suspended Trading—How should shares be valued? In which bucket should the be disclosed?
- Bifurcating securities among disclosure buckets—Is pricing impacted or only disclosure?
- Should FASB revisit P*Q given that fund's may need to disaggregate holdings for liquidity disclosure and analysis purposes?
- Does Swing Pricing work? Will it be objective or subjective?
- Will three day minimum % of liquid assets be determined consistently?
- Will the changes protect investors?

Observations

- Liquidity a spectrum – Not Binary
- Swing Pricing Mechanics open to judgement
- Prohibition on Blockage Discounts could be under pressure

Investing in “private” investments (including suspended shares) requires consideration of:

- Use of level 3 inputs (does the Fund have a framework for valuation)
- Impact of level 3 disclosures
- Impact of the 15% illiquid rule; New investment in illiquid positions curtailed when 15% limit exceeded
- Impact on comparability and investor choices based on new disclosures bucketing liquidity

Next Steps

1. Read & Understand Proposed Rules
<https://www.sec.gov/rules/proposed/2015/33-9922.pdf>
2. Respond to SEC's questions
3. Begin assessment of how to implement the proposed rules
4. Assess the magnitude of differences between the new liquidity framework and the historical financial reporting framework
5. Enhance valuation process to ensure consistency in underlying approach to determining value for liquidity reporting and financial reporting

Questions?

Contact Us

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Duff & Phelps

Dedicated to Delivering Value

Valuation and Corporate Finance Advisors

- More than 7,500 engagements performed in 2014
- 3,000 clients including more than 40% of the S&P 500

2,000+ Employees in more than 70 offices globally

Advisory Capability

- Valuation Advisory
- Dispute and Legal Management Consulting
- Mergers and Acquisitions
- Transaction Opinions
- Restructuring
- Alternative Asset Advisory
- Compliance and Regulatory Consulting
- Tax Services

HISTORY

- **1932-1994**
Duff & Phelps founded and evolves into diversified financial services firm
- **1994**
Credit ratings business spun-off
- **2005**
Acquired Corporate Value Consulting (CVC) from Standard & Poor's
- **2007-2012**
Listed on the NYSE

Financial advisor to examiner in Lehman Brothers bankruptcy

Engaged by the Congressional Oversight Panel on the Troubled Asset Relief Program

Acquired 14 complementary businesses to expand our service offering
- **2013**
Taken private by The Carlyle Group, Stone Point Capital, Pictet & Cie, Edmond de Rothschild Group and Duff & Phelps Management Team
- **2015**
Acquired Kinetic Partners and launched Compliance and Regulatory Consulting practice
- Acquired American Appraisal, significantly enhancing our global Valuation practice

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We are the largest independent valuation advisory firm.

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#1 for IP Litigation Consulting in the U.S.²

#3 U.S. Middle Market M&A Advisor³

Top 10 for U.S. Restructuring Cases⁴

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Over **7,500** engagements in 2014 for more than **3,000** clients

Nearly **4,000** valuation advisory engagements in 2014 for more than **1,700** clients

Portfolio valuation advisory services for over **70%** of top-tier private equity firms in 2014

Over **1,000** Fairness and Solvency Opinions for **\$2 trillion** in deal value since 2005

1. Source: Thomson Financial Securities Data. Full years 2010 through 2014.

2. Source: 2014 National Law Journal "Best of" Awards.

3. Source: Thomson Financial Securities Data. Full years 2012 through 2014.

4. Source: The Deal. Full Year 2014 League Table.

Our Services

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Distressed M&A and Special Situations
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Commercial and Shareholder Disputes
Fraud, Forensic and Investigative Services
M&A Purchase Price Disputes and Arbitration
Bankruptcy Litigation
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Monitoring Trustee Services
Forensic Technology and Analytics

Legal Management Consulting

Technology
Strategy and Operations
Information Governance

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U.S. Securities and Exchange Commission



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The Appraisal Foundation



Institute of Management Accountants

Portfolio Valuation Advisory Services

*Duff & Phelps assists clients with **design and implementation of best-in-class valuation policies and processes**, including on-going review of valuation procedures and conclusions to ensure best practices.*

Market Leader

- We review over **5,000 illiquid investment positions** with an aggregate value of approximately **\$225 billion** on a quarterly basis.
- Our client base consists of over **300 alternative asset fund managers and investors**, including:
 - **80% of the 10 largest** private equity firms
 - **40% of the 50 largest** hedge funds
 - **70% of the 10 largest** BDCs
 - Investors – ranging from small family offices to large public pension funds

Thought Leader

- We are at the forefront of the industry's leading committees on valuation processes, guidelines, and regulations:
 - **IPEV** – Board Member
 - **ILPA** – Special Advisor
 - **AICPA PE/VC Valuation Guide Task Force** – Member
 - **Limited Partners Association** – Board Member
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 - **Managed Funds Association** – Sustaining Member
- Leadership on drafting **IPEV** and **PEIGG** private equity valuation guidelines
- Development of Duff & Phelps Created Value Attribution Framework.

Chris Franzek

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Chris Franzek is a managing director in the New York office and part of the Valuation Advisory Services business unit. He has more than 15 years of financial and valuation experience.

Chris specializes in the valuation of illiquid securities for hedge funds, private equity funds, business development corporations and fund of funds. He has performed valuations of some of the largest and most complex portfolios of private loans, private equity interests, real estate and derivative securities. Chris' hedge fund experience includes performing quarterly analyses of private loans, private equity and real estate positions, and various derivative securities. His private equity experience includes the valuation of private equity investments as well as limited partnership (LP) interests, including four of the largest private equity LP-backed collateralized fund obligations to date. Chris also has extensive experience valuing private equity investments and portfolios, having analyzed over 3,000 private equity portfolio companies in the past five years.

Chris has performed a variety of valuations and decision support analyses for both public and private companies across many industries including the consumer products, apparel, chemicals, energy, hospitality/gaming, healthcare, industrial products, internet, pharmaceutical, publishing, retail and telecommunications industries. He also performed valuations of portfolio companies in connection with purchase price allocations under IFRS 3: Business Combinations and SFAS 141: Business Combinations and Intangible Assets and option pricing.

Prior to joining Duff & Phelps, Chris was a senior manager at BearingPoint, Inc. where he led their New York Valuation and Financial Advisory Services Practice.

Chris received his M.B.A. in finance from Cornell University's Johnson Graduate School of Management and his B.A. in economics from the University of Rochester. He is also a senior member of the American Society of Appraisers.

For more information about our global locations and services, please visit:
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About Duff & Phelps

Duff & Phelps is the premier global valuation and corporate finance advisor with expertise in complex valuation, dispute and legal management consulting, M&A, restructuring, and compliance and regulatory consulting. The firm's more than 2,000 employees serve a diverse range of clients from offices around the world. For more information, visit www.duffandphelps.com.

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Panel Discussion

IMPACT OF LIQUIDITY RISK MANAGEMENT PROPOSALS

IAN BLANCE – VOLTAIRE ADVISORS
(MODERATOR)

CHRIS FRANZEK – DUFF & PHELPS

NATHAN GREENE – SHEARMAN &
STERLING

VARUN PAWAR – BLOOMBERG

Panel Questions

1. Liquidity has been top of the agenda for financial firms and regulators since the crisis of 2008. However, it remains difficult to both define and estimate in a way that is acceptable to stakeholders. Why is that?
2. Does the panel believe that the proposals for liquidity classification by the SEC are workable for mutual funds? What kind of data and information would be required to implement these?
3. How frequently do the panel think that individual asset liquidity classifications and overall portfolio liquidity risk should be reviewed?
4. What does the panel believe is an appropriate % for the 'three day liquid asset minimum' for a regular mutual fund?
5. Does the panel think that Swing Pricing is desirable (or even possible) for US mutual funds?



Voltaire
ADVISORS

Valuation, Liquidity & Derivatives

NEW YORK, 11TH FEBRUARY 2016

New SEC Derivative Management Proposals

JAY BARIS,
CHAIR, INVESTMENT
MANAGEMENT PRACTICE
MORRISON & FOERSTER LLP

http://fundboardviews.com/Content_Free/Viewpoints-JayBaris-derivatives.aspx

Panel Discussion – Impact of Derivatives Proposals

IMPACT OF DERIVATIVES PROPOSALS

IAN BLANCE – VOLTAIRE ADVISORS
(MODERATOR)

JAY BARIS – MORRISON & FOERSTER

KENT KNUDSON – PWC

Panel Questions

1. Does the panel think that the SEC proposals will be implemented as presented? If not, what changes can be envisaged?
2. What will be the main impact on funds use of derivatives from the proposals?
3. How difficult do the panel envisage the development of derivatives risk management programs and the appointment of dedicated risk managers?
4. What will be the impact on fund board directors and officers if these proposals are implemented?
5. Does the panel believe that mutual funds and their advisers are currently capable of implementing these proposals?



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