

The Ascendant Investment Adviser Compliance Conference

A BOLD NEW WORLD OF COMPLIANCE: 2010

Staying on Top of Changing Regulations & Examinations,

Understanding Your Fiduciary Duty

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Remarks of Cindy Fornelli

Good afternoon,

It is great to be among so many friends, new and old. For those of you who don't know me, I'm here not so much in my current capacity as the Executive Director of the Center for Audit Quality – which is a public policy advocacy organization for issues affecting public company auditors – but mostly because of my prior experience as the deputy director of the SEC's division of investment management, so I'm a securities lawyer and not an accountant! Actually, though, there is quite a bit of overlap between my two worlds with respect to fair value accounting, which is what I'm here to talk to you about today.

Before I get started, though, I'd like to thank Jackie, John, Sally, Keith and the other Ascendant staff for putting together this great conference; there is something here for everyone.

Fair value accounting, or mark-to-market accounting, has been one of the favored villains of the financial melt-down, especially by financial institutions that held a number of increasingly toxic assets on their books. Although people like to blame fair value for the credit crisis, there is research that shows that it was not to blame.

In December 2008, the SEC issued a Congressionally-mandated report on the impact of fair value accounting on the economic crisis. The report concluded that fair-value accounting had not caused the credit crisis. Rather, the report stated that bank failures in the United States and that the credit crisis appeared to be the result of growing probable credit losses, asset quality concerns, and, in certain cases, eroding lender and investor confidence due to risky investments.

And, just last month, the Federal Reserve Bank of Boston released a working paper which found that for most large banks it analyzed, "fair value

adjustments had only a small percentage impact on regulatory capital; thus the link between fair value and capital destruction is not evident.”

We at the CAQ support fair value accounting because it provides investors with the most reliable and transparent information of an asset’s or a liability’s current value, thus providing investors with valuable information when making investment decisions. Increased transparency in financial reporting enhances investor confidence in the capital markets.

Regardless of your views on the role of fair value accounting in the financial meltdown or its value to investors, as compliance executives for investment advisers you need to care about fair value accounting if for no other reason than because the SEC does. Valuations by investment advisers are a perennial focus of SEC examinations and enforcement actions and now more than ever due to the increasing numbers of hard to value and illiquid securities in portfolios. The SEC will be focused on whether advisers have valuation procedures, whether they are implementing those procedures and whether they are appropriately disclosing to their clients the risks of investing in illiquid securities.

Accurate valuation is important for several reasons, not least of which is because many advisers charge fees based on the value of their clients’ assets.

Mutual fund and hedge fund subscriptions and redemptions are based on net asset values of the funds, which must accurately reflect the value of the underlying assets. If, for example, values are too high, shareholders that redeem will get more than they should and those that purchase will pay more than they should. Also, inflated valuations could result in overstatement of performance. All of which can be in violation of the Advisers Act.

Advisers must have in place adequate processes and procedures related to risk management, valuation and accounting. But it is not enough to have these policies and procedures, the policies and procedures also must be followed and the risks associated with investing in illiquid securities must be disclosed to clients. For example, in a recent SEC enforcement action, an adviser was sanctioned not based on its policy, but rather because of the implementation and operation of it. The SEC found that the adviser did not test or monitor the policy and ended up conducting the valuations itself at unfair values.

Today I'll discuss what you need to know about developing, implementing and operating a good valuation program in our Brave New World. Let's start by discussion the key provisions of FAS 157 as it relates to fair value measurements.

In 2006, the FASB issued a new standard, FAS No. 157, *Fair Value Measurements*, which provided a single, consistent definition of fair value, established a common framework for developing fair value estimates, and required expanded disclosures about those estimates.

FASB issued FAS 157 to address the complexities caused by differing definitions of fair value. Stated differently, FAS 157 itself does not prescribe any particular accounting treatment or require fair value accounting but does specify how fair value is to be determined when fair value is required by another standard.

FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the principal or most advantageous market at the measurement date. The definition focuses on the price that would be received to sell the asset or paid to transfer the liability – in other words, the exit price – and not on the price that would be paid to acquire the asset or received to assume the liability – or the entry price. Further, FAS 157 states that fair value is a market-based measurement, not an entity-specific measurement, and should be determined based on the assumptions that market participants would use in valuing an asset.

An analogy: FAS 157, if applied to valuing your house, is the price at which your house would sell today, in the current market, regardless of what you paid for it 3 years ago or what you anticipate it might sell for in 3 years.

FAS 157 establishes a three level fair value hierarchy. Entities must use prices for measuring fair value beginning with the highest level possible (Level 1), and where not available, going to the next lower level. The three levels for measuring fair value are as follows:

Level 1 values are quoted prices in active markets for identical assets or liabilities that the company has the ability to access at the measurement date.

Level 2 values are those other than quoted prices that are observable for the asset or liability, either directly or indirectly. Examples include:

Quoted prices for similar assets or liabilities in active markets;

Quoted prices for identical or similar assets or liabilities in markets that are not active (for example, brokered markets); and

Inputs other than quoted prices that are observable for the asset or liability (such as, interest rates, credit risks and default rates).

Level 3 values are unobservable inputs for the asset or liability.

Level 3 values are intended to be used in situations where there is little, if any, market activity for the asset or liability at the measurement date.

Level 3 unobservable inputs should reflect the company's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk and the effect of a restriction on the sale or use of an asset).

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

In addition, this past January, the FASB approved Accounting Standards Update No. 2010-06, which enhances disclosures and provided clarifications related to an entity's disclosures of fair value measurements. I won't go into the

details, but you should be aware of these enhanced disclosure requirements and work with your accountant to make sure they are made.

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

I know this is complicated. You should consult your accountant when developing and reviewing your valuation program. There are many helpful legal and accounting resources available on-line as well.

OK, now, that I've gone over the technical accounting requirements, let's talk a bit more about how all of this is relevant to you. As I discussed previously, developing policies and procedures related to the valuation policy is of critical importance to providing investors with reliable information regarding the valuation of their investments. Reluctance to fair value or mark down prices

cannot take precedence over the firm's pricing procedures — investors and fund shareholders have a right to know the current value of their holdings.

One acceptable and often used valuation policy is a 3-tiered approach:

The first tier, which is preferred, is to use a third party pricing vendor;

The next best method is to obtain values by 1 or more broker/dealers;

and the least preferred method is to have the valuations done by the portfolio management team.

Be forewarned, however. Even though the preferred methods of valuation include the use of third parties – either through a pricing vendor or a broker/dealer – the investment adviser, as the ultimate provider of information to those whom you advise, are responsible for the fair value information provided to their investors, regardless of whether or not a third party is engaged to provide the fair value information.

So, an adviser needs to understand where each security's valuation resides in the fair value hierarchy – FAS 157 Level 1, 2 or 3, as this will dictate the manner in which the valuation is conducted, as well as the related disclosure to investors. While this may not be particularly challenging for level 1 securities where there is

an active market and fair value information is readily available, it can become more difficult when evaluating whether a security belongs in level 2 or level 3. For example, the recent economic crisis has resulted in substantially decreasing the liquidity for certain types of investments – such as the amount of market information that exists to assist in valuing investments has declined dramatically.

Further, for Level 2 or Level 3 measurements, valuations will typically require significant judgment. Therefore, to the extent advisers rely on third party pricing services or broker/dealers, the adviser needs to understand the valuation techniques and assumptions used by the third party and also be comfortable that the techniques are in accordance with GAAP. Questions to ask include: Is the third party using information from active markets, similar markets or their own internal valuation model? Is the price from a broker indicative of an offer to buy, or rather the broker's estimate of fair value based on internal information? Does the quote from the pricing service or broker/dealer include a disclaimer whereby the entity takes no responsibility for the valuation for the user's intended purpose?

The adviser also should understand:

1. whether the valuation techniques used by the third party have been applied consistently between periods;
2. the assumptions that have a significant impact on the valuation;
3. how the 3rd party derived information related to those assumptions;
4. the alternatives (range of reasonableness) for each of the assumptions;
5. the sensitivity of the various assumptions to the overall valuation;
and
6. the rationale behind the third party's determination of the appropriate measure to use in the valuation.

All of the above should provide the adviser with a basis for evaluating the adequacy of the valuations provided from others, as well as what is needed in order to make the required disclosures in the financial statements.

In situations where the adviser performs the valuations in-house, which is the least preferred method, processes and controls also must exist for all of the areas just discussed. Such situations will likely require enhanced involvement from the adviser's valuation committee – especially in situations where

investment values are determined by Level 2 or Level 3 inputs from our FAS 157 hierarchy.

Advisers and valuation committees should consider performing the following checks as part of their on-going evaluation and testing of the adviser's valuation policies, procedures and practices:

1. For items where there is a readily available market value (Level 1 input), you consider comparing prices received upon a subsequent transaction against the most recent valuation to see how accurate it was;
2. You should consider receiving multiple quotes from pricing services and/or broker dealers (more effective when Level 2 or Level 3 inputs are involved); and
3. If holding a large block of securities, by selling a portion as a test of the valuation (which admittedly can be difficult with very illiquid securities and not fit within an investment strategy).

Some additional basic principles that you as a compliance professional should make sure your firm follows with respect to your valuation program and methodology are:

1. To have a written policy – while this may be common sense, you need to make sure you have a formalized policy for valuing assets and that the policy is disclosed properly, including how errors and exceptions will be handled.
2. Consistency – Do the prices used to value clients' positions consistently reflect the prices that would be paid in the current market? Frequent changes in the valuation process, analytical tools or data sources used are red flags for potential problems. Any changes should be explained and supported with documented rationale.
3. Reproducible – it is not sufficient to merely have a policy – the results must be reproducible by subsequent evaluators. This means that you must document your processes, as it is inevitable that judgment calls will be made in determining the value of an illiquid security. The justifications for these judgments should be documented in writing and be available for inspection.
4. Verifiable – Advisers need to perform on-going due diligence on the methodologies used – including those used by third parties.

5. Correctable -- Mistakes will be made, so provide checks and balances and test. Errors need to be corrected quickly and in a manner that is consistent with disclosures and fair to the client.
6. Supervised -- Senior management and Compliance should actively oversee and supervise valuation procedures and be made aware of, and research, any exceptions.
7. Separated – someone in addition to the portfolio management team should have responsibility for valuing assets and the portfolio manager should not directly compensate those who do.
8. Experienced -- Examiners will want to understand the level of expertise and sophistication of the personnel who are involved in pricing, and if there is some level of independence in the pricing process.

Procedures such as these can provide advisers and their valuation committees with valuable information to evaluate the adequacy of fair value measurements.

Developing a process that contains the elements discussed above is essential to performing reliable valuations, and as mentioned above will be a major focus of the SEC as part of their inspections, as well as by the adviser's independent auditor.

It is a Brave New World out there and I applaud you for the tough job you have, particularly in this touch economic climate. It is good to be here with you and I encourage you to take advantage of the networking opportunities. Share your war stories, best practices and solutions to the problems that all investment adviser compliance personnel share.

Thank you and I'm happy to answer your questions.