The *Revenant* of Fair Value Cometh for Fixed Income Markets

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Valuations of fixed income securities might not be the first thing you think of when you see or hear the term "revenant" (queue the Leo DiCaprio headshots, bad beard jokes, and giant grizzly bears). You see, in folklore, a *revenant* is an animated corpse believed to have been revived from death to haunt the living. Reviving its ghostly past, the issues surrounding fixed income securities and (in particular) the focus from regulators seems to be resuscitated every few years. In fact, during several 2020 examinations, SEC staff indicated that firms cannot rely on fixed income security valuations provided by major custodians. Rather these firms should have a process in place to value the fixed income security – on their own – in order to determine the fair value. Scary, we know.

This approach offered by the SEC Staff results in some inherent conflicts, particularly when those adviser firms make the determination to value the securities higher than the custodian.[1] That said, firms that do well to develop their own process of determining fair value might be able to avoid this grisly ordeal altogether. Let this article serve as both a forewarning of the regulators' renewed concerns and a resource to help you evaluate your firm's own process and related internal controls for valuing fixed income securities.

A Remembrance of Fixed Income (from the Regulators Perspective)

Before we start digging up skeletons inherent in these fixed income valuation issues, we offer a brief tribute on the life and recent impact of bond fair valuation from the regulators:

- 2002: FINRA's TRACE rules require reporting of secondary market transactions in eligible fixed income securities.[2]
- 2003: SEC promulgated Rule 206(4)-7 and in the issuing relates stated that adviser's policies and procedures should address, among other things, "processes to value client holdings and assess fees based on those valuations."[3]
- 2008: SEC approved the MSRB's EMMA as the "single centralized repository for the electronic collection and availability of information about municipal securities outstanding in the secondary market."[4]
- 2010: Dodd-Frank Wall Street Reform and Consumer Protection Act significantly impacted the municipal securities and asset-backed securities industry.[5]
- 2012: SEC issues a special report on the municipal securities market.[6]
- 2015: FINRA issues a Notice to Members reiterating best execution obligations, including "additional considerations" for fixed income securities.[7]
- 2017: The SEC establishes the Fixed Income Market Structure Advisory Committee "to provide the Commission with diverse perspectives on the structure and operations of the U.S. fixed income markets, as well as advice and recommendations on matters related to fixed income market structure."[8]
- 2018: FINRA and MSRB implement rule amendments to include the disclosure of fixed-income mark-ups and mark-downs for retail customer trades in corporate, agency and municipal debt securities.[9]
- 2019: FINRA proposed to enhance the collection and dissemination of new issue reference data for corporate bonds[10] and obtained approval to publish aggregated transaction information on U.S. Treasury Securities.[11]

1. One can imagine a scenario in a different SEC exam where the Staff might question why the firm valued the security higher than a major custodian did—particularly where the custodian will typically have far greater resources and focused intellectual capital to determine the actual price of the security.
2. Trade Reporting and Compliance Engine (TRACE); https://www.finra.org/filing-reporting/trace#overview
3. https://www.sec.gov/rules/final/ia-2204.htm
4. MSRB's Electronic Municipal Market Access system ("EMMA"); https://www.sec.gov/rules/final/2008/34-59062.pdf
5. https://www.sec.gov/spotlight/dodd-frank.shtml
6. https://www.sec.gov/news/studies/2012/munireport073112.pdf
7. Notice to Members 15-46; https://www.finra.org/rules-guidance/notices/15-46
8. https://www.sec.gov/spotlight/fixed-income-advisory-committee
9. https://www.finra.org/rules-guidance/guidance/reports/2018-report-exam-findings/fixed-income-mark-disclosure
10. https://www.finra.org/rules-guidance/rule-filings/sr-finra-2019-008
11. https://www.finra.org/rules-guidance/rule-filings/sr-finra-2019-028

- April 2020: SEC proposed a new rule (Rule 2a-5) under the Investment Company Act of 1940 that would address valuation practices for investment companies.[12]
- June 2020: SEC's Fixed Income Market Structure Advisory Committee remotely met to discuss market transparency[13] and the "Microstructure of Fixed Income Markets."[14]

And broker-dealers, don't forget about FOCUS filings. The SEC has issued several no-action letters[15] on valuation of securities for purposes of net capital computation and requires that securities not readily marketable be calculated at estimated fair value for FOCUS reporting purposes.[16] Likewise, advisers, the SEC's instructions for determining regulatory assets under management is "the same method used to report account values to clients or to calculate fees for investment advisory services.[17]

So, how can we help our firms prepare for the fixed income valuation *revenant* (and increased regulatory scrutiny)?

Understand the Inputs to Fair Valuation

First and foremost, firms and relevant personnel must have a solid, working knowledge of the fair valuation standard used by the firm and its clients. There are many fair valuation standards.[18] In fact, in 2011, the SEC stated, "[w]hile many advisers will calculate fair value in accordance with GAAP or another international accounting standard, other advisers acting consistently and in good faith may utilize another fair valuation standard."[19] With that said, this article will focus on the application of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 820 on Fair Value Measurement. (Interestingly, the SEC's recently proposed SEC Rule 2a-5 under the Investment Company Act of 1940 aligns, in several respects, with ASC 820.[20])

According to ASC Topic 820, fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[21] This definition can be distilled down into five (5) components that may be used to create a fair valuation processing framework[22] :

The [price] that would be
received to sell an [asset] or paid to transfer a liability
in an [orderly transaction]
between [market participants]
at the [measurement date]

In other words, the fair value measurement is the point within a range of values that is most representative of fair value under the circumstances. By assessing each of the five components for the FASB ASC 820 framework – (1) Asset/Liability, (2) Orderly Transaction, (3) Market Participants, (4) Measurement Date and (5) Exit Price – a firm can begin to establish an objective fair valuation process and develop related internal controls for valuing fixed income securities.

12. https://www.sec.gov/rules/proposed/2020/ic-33845.pdf
13. https://www.sec.gov/spotlight/fixed-income-advisory-committee
14. https://www.sec.gov/spotlight/fixed-income-advisory-committee/survey-of-microstructure-of-fixed-income-market.pdf
15. https://www.finra.org/sites/default/files/InterpretationsFOR/p037763.pdf
16. https://www.sec.gov/files/formx-17a-5_22.pdf
17. https://www.sec.gov/rules/final/2016/ia-4509-appendix-b.pdf
18. For example, GASB Statement No. 72 and IFRS 13
19. https://www.sec.gov/rules/final/2011/ia-3222.pdf
20. https://www.sec.gov/news/press-release/2020-93
21. https://asc.fasb.org/glossarysection&trid=2176480
22. https://www.pwc.com/us/en/cfodirect/assets/pdf/accounting-guides/fair-value-measurements-global-guide.pdf

Understand the Fair Valuation Inputs Relative to Fixed Income Securities

Once the firm's personnel have a solid understand of the standard, the firm must begin applying those standards to the fixed income securities trades/managed by the firm (*i.e.*, addressing those fair valuation, fixed-income hauntings, if you will). Which firm personnel are knowledgeable and actively trading in these securities? What information should the firm evaluate? When should we begin the valuation process? Where will the firm obtain objective pricing information? How will the firm determine a final fair valuation? Let's examine each of the five components of the FASB ASC 820 framework, as it may be applied to valuing fixed income securities.

Asset/Liability – For fixed income securities, the valuation process may begin with delineating the various subtypes within the asset class. One approach is to segregate by underlying asset type (*e.g.*, bank loan, auto loan, municipal debt), security structure (*e.g.*, tranche, support level), or duration or maturity schedules (*e.g.*, short-term, 5 – 15 year). For example:

Asset Group	Subclassification	Security Type
FIXED INCOME	AUTO LOAN RECEIVALBE	ABS AUTO
FIXED INCOME	CORPORATE BONDS	US DOMESTIC
FIXED INCOME	CORPORATE BONDS	YANKEE
FIXED INCOME	CREDIT CARD RECEIVABLE	ABS CARD
FIXED INCOME	FHLMC	MBS 15yr
FIXED INCOME	FNMA	MBS 20yr
FIXED INCOME	GNMA 1	MBS 30yr
FIXED INCOME	MUNICIPALS	FIXED
FIXED INCOME	MUNICIPALS	FIXED, OID

Orderly Transaction – An orderly transaction allows for usual market activities and assumes that the transaction is conducted in the principal market, from the perspective of the client (reporting entity). To assess principal market and, thus, orderly transaction, one must determine where (by what means) such types of fixed income securities are most frequently traded based on volume and/or level of activity. While a few fixed income securities, for example marketable U.S. Treasury bills, notes and bonds,[23] are actively traded on both primary and secondary markets, most fixed income securities are traded over-the-counter (OTC) in the secondary market and involve broker/dealers (*see discussion below on Market Participants*).

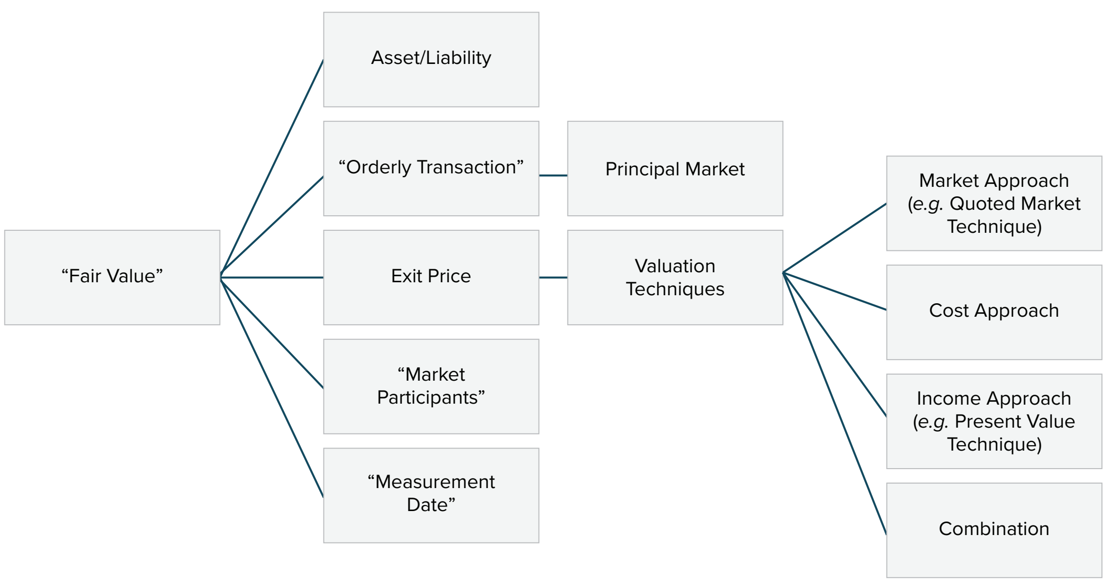
Market Participants – Buyers and sellers that are knowledgeable, able and willing to transact in the specific asset/liability and independent of the client (reporting entity) would be considered Market Participants. As mentioned previously, for fixed income securities these are typically broker-dealers that have large trading operations (*i.e.*, big books of business and/or inventories) or that cover a specialty niche area within the fixed income space (*e.g.*, boutique regional shops).

23. https://www.treasurydirect.gov/instit/marketables/tbills/tbills.htm

Measurement Date – The date as of which the exit price is determined for the applicable asset/liability. The measurement date for fixed income securities may be nuanced, if such date falls on a principal and interest payment date, maturity date, or physical delivery settlement date. To that end, firms must develop internal control activities, as part of the pricing reconciliation review (discussed below), that address these aspects of valuating fixed income securities.

Exit Price – Validating or establishing the exit price for fixed income securities -- the price that would be received to sell an asset (or paid to transfer a liability) – actually begins before the measurement date by establishing a pricing verification process. The pricing verification process involves establishing a pricing hierarchy, a stale price review, and a pricing reconciliation review.

- *Pricing Hierarchy* – The pricing hierarchy is a pre-determined (pre-approved) approach for pricing fixed income securities. The pricing hierarchy should set forth the primary, secondary and tertiary pricing sources, the pricing logic, valuation point and pricing tolerance. (*See also Tab 1 of the Fair Valuation Template*). In selecting the pricing sources, a firm must determine what valuation technique(s) are used by the source(s).[24] A combination of the market and income approaches are most frequently applied to valuing fixed income securities.
- *Stale Pricing Review* – In the event that the primary, secondary and tertiary pricing sources are unavailable or fail to provide an updated price over a given period (aka "stale" price), a process should be established to seek an alternative pricing method. Often times, for fixed income securities, this involves the portfolio manager or representative seeking a current bid price from active broker/dealers (commonly referred to as manager-priced).
- *Pricing Verification* – At some recurring interval (e.g., monthly or quarterly), all pricing information should be reviewed and validated, including addressing all pricing exceptions (e.g., stale, unpriced or manager priced securities) and ensuring that the pricing hierarchy (and related valuation technique(s)) is still relevant for the securities being traded/managed by the firm. (*See also Tab 2 of the Fair Valuation Template*).



Consistently applying this pricing verification process throughout the reporting period will create an objective starting point for validating the exit price for the securities. Then, at the measurement (reporting) date, the current price or valuation may need to be adjusted for market participants' assumptions and/or market conditions/circumstances.

24. FASB ASC 820 allows for three valuation approaches (market approach, income approach or cost approach) and one or more of the approaches may be selected, based on the circumstances and availability of sufficient data. For additional information, refer to https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/ASC/Roadmaps/us-aers-a-roadmap-to-fair-value-measurements-and-disclosures.pdf

Further Mitigating the Risks of Fixed Income Fair Valuation

No one likes skeletons buried in the closet. And rather than let your fair valuation policy for fixed income securities lie concealed deep in your compliance manual, building a successful valuation process will often involve supplementing any internal controls with (1) education of the firm's employees and clients (and even regulators and auditors, where appropriate), and (2) proper disclosures to clients, investors, and other firm stakeholders.

At the most basic level, firms must document the steps it has taken to properly value these securities in its compliance manual and other relevant policies and procedures. The benefit of doing this is two-fold. First, having such procedures formally established will go a long way to demonstrating to any regulator or auditor the thoughtful and systematic approach the firm taken. Second, these procedures will help train and educate the employee about the nature and effect of these securities, and perhaps more importantly, arm them with the information they need to establish a dialogue with the client. This dialogue with the client then becomes a natural extension of the firm's valuation policies of fixed income securities disclosed in the Form ADV Part 2A, and may also serve to enhance any additional disclosures in the firm's advisory agreements or other informational materials provided to the investor at the outset of the relationship.

Conclusion

And so, it goes, the *revenant* is here -- haunting all firms engaged in fixed income activities. Regardless of the renewed focus from regulators in recent examinations, the truth is the challenges facing fixed income securities never died or went away. As detailed above, ghastly consequences could be in store for firms unwilling to review their fixed income valuation policies and recognize the applicable fair valuation standard. As it relates to FASB ASC 820, firms must wield the five components (Asset/Liability, Orderly Transaction, Exit Price, Market Participants, and Measurement Date) to mitigate regulatory, operational and administrative risks. Finally, firms should supplement the fair valuation process with client disclosures and firm-wide education. Will it be difficult? Yes. Wrought with peril? Perhaps. But, come on, substantiating the firm's valuations of fixed income securities has got to be easier than trying to fight off a grizzly bear. Right? ■

Security Type	Pricing Source	Pricing Source	Pricing Source	Pricing Logic
FIXED INCOME				
Corporate Bonds	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Municipal Bonds	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Agency MBS	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Non-Agency MBS/ABS	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Government Bonds	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Convertible Bonds	Thomson Reuters	JPM Direct	Bloomberg	Evaluated Bid
Bank Loans/Term Loans	Markit	Refinitive	Bloomberg	Evaluated Bid
Short Terms	Thomson Reuters	Refinitive	Bloomberg	Evaluated Bid