Committees host SEC reps during joint CPE session

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In a first-of-its-kind meeting, members of four NYSSCPA committees—Investment Management, Family Office, Investment Companies, Private Equity and Venture Capital—held a joint continuing professional education session on Jan. 8. The event featured speakers from the SEC, who provided regulatory updates, as well as a portfolio manager from an asset management company who gave an overview of due diligence in investment management.

Christina K. Catalina, the Investment Companies Committee chair, said that she and **Dov Braun,** the Investment Management Committee chair, often worked together on projects. When they discussed holding a joint session, Braun suggested they invite other committees to take part, with the goal of sharing resources and networking, she said.

From there, Catalina said, they sought out SEC staff members Jaime Eichen, chief accountant for the commission's Division of Investment Management, and Megan Monroe, the assistant chief accountant in the same division, as well as Chris Heasman, a director and portfolio manager and analyst from Lazard Asset Management LLC, as speakers because "we wanted to find a collective topic that we would all be interested in."

During the session, Monroe discussed the division's observations regarding the disclosure requirements contained in ASU 2011-04, a new standard that went into effect at the end of 2011 and pertains mainly to fair value measurement and disclosure requirements.

In terms of quantitative disclosures, she said that the staff had observed that filers were using an excessively wide range of unobservable inputs in their tabular disclosure and suggested that they also provide a weighted average of the range. She added that in disclosing the type of unobservable inputs in the tabular disclosure, more consistency and specificity were needed, and reminded attendees that all significant unobservable inputs used in the valuation should be included in the disclosure.

Monroe said the staff had also observed that some investment companies don't appear to address their valuation process for level three measurements in the footnote disclosures and, furthermore, sometimes omitted disclosures regarding the interrelationship between unobservable inputs used and how those interrelationships might magnify or mitigate the effect that changes in these inputs would have on fair value.

Eichen offered examples of when funds lacked appropriate valuation and why. For instance, she referenced a business development company (BDC) that she said had overvalued its portfolio, made up mostly of debt securities of noncontrolled portfolio companies and collateralized loan obligations. According to Eichen, the BDC's valuations did not comply with Generally Accepted Accounting Principles; because they did not take market transactions and recent quotes into consideration, they did not, therefore, represent fair value. Moreover, she said, the valuations of debt securities of noncontrolled companies did not represent a current exit price since the company used the enterprise value methodology, which calculated whether, in the event of a default or liquidation of the issuer, the company would receive full repayment of its loan. This ultimately caused the company to restate its financial statements as well as several of their 10-Qs. The company eventually settled toward the end of last year.

Operational due diligence

In a discussion about reducing the risk of fraud, Heasman said that Lazard takes a conservative approach with investments and begins by looking closely at the fund manager. He explained that, when evaluating a fund, the company looks at the ability and stability of the manager, as well as the investment risk management process and the sustainability of the manager's returns. When examining the entity itself, he said that his company looks at the quality of people, the preparations in place to support investment activity, business risk management procedures, the type of technology used and the level of information provided by the fund manager, as this relates to the quality and disclosure of positions.

These factors involve more than examining a sheet of data. Operational due diligence—looking at how the company functions as a business—has gained increased importance since the most recent financial crisis, Heasman said.

He added that it's important to verify that the services offered are what's actually being delivered. They can include a look at policies and procedures and how they are documented, knowing who has the power in the fund to make amendments to the pricing in the portfolio, emergency backup and recovery processes, and knowing whether these processes are tested on a regular basis.

Heasman said that even the condition of the office is a factor, since something as mundane as that can yield helpful information.

"We know what it costs to rent square footage and to employ people and populate each of these different parts, so we can calculate fairly easily what the breakeven is for assets in management to be viable," he said.

Heasman recommended that background checks be conducted at least annually on fund managers, noting that his company has declined numerous investments because of what comes out in them.

"There are managers out there today … who have generated extraordinary returns and done very well for their investments, but one thing we found was when you see a pattern of behavior that suggests they may not be the best fiduciary, you don't want to invest with them," he said. This, he added, has helped keep the company away from fund managers who "have not behaved well when things get tough."

"You can do all the due diligence you like … but if you don't take into account the behavioral components revealed through background checks and reference checks, you're setting yourself up for a problem at some point," he said.

Another component of operational due diligence is random visits. Heasman said that representatives from his company will sometimes drop in to see how things are going, which has occasionally uncovered major concerns about those they have invested in. The surprise factor, he added, was important because if people know about an appointment in advance, events can be staged. As an example, he referenced a time when some people from his company went to inspect a warehouse that was supposedly full of goods. They found that the warehouse was actually empty, though there were workers walking around in overalls. When the workers were asked where the goods were, they said they had been shipped out the previous night.

"Turned out that a lot of those people were hired actors!" he said.

Heasman also described an instance in which his company had vetted a manager in Dallas. It seemed strange, he said, that this manager's office was in a strip mall and the address seemed to belong to a hair salon.

"When we checked, we found the back office was where this fund operated. We knocked and saw a bunch of people with their feet on the desk and no computers on," he said. Later, it turned out this same manager was found to have defrauded the Art Institute of Chicago for $40 million.

Still, Heasman admitted that events like these have been getting less frequent in more recent years. The environment was a lot less regulated in the past, he said, meaning that it was easier for people to launch a fund and attract investments.

"In those days, a lot of folks would use word of mouth to identify a good manager," he said. "But those days are gone and, as a result of a number of instances I described, that sort of behavior and irregularities we encounter have declined significantly over the last few years."

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