Raise High the Price

An Investigation of Pricing Investigations

"[We] can't mark any of our positions [to market price], and obviously that's what saves us having this enormous mark to market. If we start buying the physical bonds back then any accountant is going to turn around and say, well, John, you know you traded at 90, you must be able to mark your bonds then."

– Conversation between AIG employees, at the time of a crisis-era margin call by Goldman Sachs.[i]

Introduction

Within certain asset classes, asset valuations are more susceptible to manipulation.

Valuations of large-cap, public equities are relatively straightforward due to the transparency of intraday and closing price information on exchanges.

Evaluating fixed-income assets, however, can be a trickier proposition. Trading in many of these assets can be sporadic. Even when trading occurs, the trades may not be *reliable* or they may not be *visible* to all market participants, given the modest reporting requirements in several over-the-counter (OTC) markets.[ii] There is also much discretion afforded to, and little transparency demanded of, the processes used to value their assets, making it all the more difficult to spot pricing anomalies.

In short, there is generally no single agreed-upon price at any point in time. Largely as a result of this opacity, the regulatory lens has been focused on hard-to-value, complex and illiquid securities, generally in the fixed-income space.

There has also been a drive to investigate the valuations of private companies, especially in the tech-startup boom, with some young billion-dollar companies (so-called "unicorns," such as Uber and Airbnb) opting to remain private for longer than what might be customary in such circumstances. The SEC has reportedly contacted large mutual funds, requesting information about how they are marking their investments in startups and other private companies.

The SEC's scrutiny of buy-side valuation practices has been growing over the last five years, under various initiatives.

"Accurate mark-to-market valuation and daily pricing allow investors to have confidence that the prices they pay and the money they receive when they sell a fund's shares are based on the real value of the fund's portfolio that day. What could be more fundamental to investors' trust and confidence than that?"

- Lori A. Richards, then director of the SEC's Office of Compliance, Inspections and Examinations (2001)

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In October 2012, the SEC's Office of Compliance Inspections and Examinations sent a letter to hedge fund managers regarding "presence examinations," noting that "[National Exam Program] staff will review advisers' valuation policies and procedures, including their methodology for fair valuing illiquid or difficult to value instruments."[iii] In July 2013 the SEC announced the creation of the Financial Reporting and Audit Task Force, aimed at helping the SEC identify "areas susceptible to fraudulent financial reporting," likely with asset valuations at least partially in mind.

Our piece explores the issues at hand. In so doing, we briefly describe the capacity and motivation for adjusting or steering the prices of financial products, and then provide timely examples of cases in which the approaches taken by firms are either being scrutinized or have been found to be in violation of acceptable standards and practices.

Price Adjustments: Motivation and Capacity

Asset managers — including hedge funds and bond-fund managers like BlackRock, PIMCO and DoubleLine Capital — can derive several benefits from *inflating* the prices of their assets.

While, from time to time, managers may also be tempted to lower prices,[iv] the inflationary motivation is typically more prominent, simply because asset managers' compensation levels are typically reflective of size and performance, with asset price inflation tending to boost both elements.

Funds and companies generally adopt one of three frameworks for valuing infrequently traded securities best categorized as self-pricing, broker-pricing or third-party pricing.

Among other options available, a fund or company might look to any or a combination of the following sources for information relevant to their pricing process:

- *The Marketplace* for recent trades in the marketplace in the securities of interest or, failing that, trades in similar securities that can act as proxies for the securities of interest
- *External Brokers* for indicative quotes[v] on the direct securities or, failing that, quotes on proxies for the securities of interest
- *Internal Traders* for their insights on market levels
- *Third-Party Price Providers* for their estimates
- *Internal Models* to try to estimate cashflows under an array of assumptions, ideally based on then-current market conditions.

Each source might produce widely disparate results.

Some apply "mark-to-market" approaches, relying on supposed or actual trades or quotes.

Higher Values Make for Higher Fees

Managers typically charge a flat fee on all assets under management (AUM) and a performance-based fee that may be triggered upon the manager's meeting certain pre-defined performance triggers.

A manager may charge a base fee of, say, 1% on all AUM, and for strong performance perhaps 30% on all positive gains over a return of 5%. Thus, if a manager is able to inflate the value of its asset under management, it can charge its base fee against a higher asset portfolio; and inflating asset valuations results in improved performance, increasing the likelihood of surpassing its performance fee hurdle of 5% and, if the 5% hurdle is met, increasing the magnitude of the performance fee to be charged.

As a tertiary benefit, strong performance can also help an asset manager promote its fund, attract new investors, and thereby grow its AUM.

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Others use "mark-to-model" approaches, dependent on ostensibly well-calibrated and accurate models. Yet others combine mark-to-market and mark-to-model techniques.

Steering the Pricing Process

Both the choice of approach taken and its implementation can be subjected to an asset manager's discretion and interests. At worst, the manager (price-seeker) may apply an outcomes-based approach to the pricing process, either actively selecting the approach or dynamically advancing the method for its execution in a way that produces that manager's desired outcome.

With management fees being directly linked to the value of the assets held, investors fear that an asset manager may be tempted to push for higher marks, even if only temporarily (for example at the end of a month, quarter, or year). The regulatory goal, therefore, is to ensure that the valuation methods that are employed reflect an honest effort to seek the most appropriate valuations, and are not unduly influenced by the asset manager's pecuniary interests.[vi]

Some examples of the potential for bias or price-steering include the following:

- When considering *market-based inputs*, asset managers can be artful in their choice of which inputs to include or exclude, or may even make their own small trades so as to provide a data input for valuing larger trades.
- It is not uncommon for managers to have cozy relationships with certain *brokers*, who might be selected to provide quotes that will yield the most beneficial results: managers might send more transactional business to cooperating brokers as a means of classical conditioning.
- *Internal traders* may be inherently biased, often having traded the products being evaluated and their performance linked to the outcomes sought.
- The use of *third-party pricing* services, a user-pays model, can be subject to price-shopping, with asset managers being able to pressure providers (or take their business elsewhere) if dissatisfied with the prices provided.
- *Internal valuation models* can be subjected to the application of optimistic assumptions that were engineered to produce pre-specified outcomes.

Examples of Valuation Disputes & Investigations

"Extend and Pretend" or "Delay and Pray"

Whether it be in the case of holding physical assets, investment securities, or even loan receivables, when valuations depend on market levels they may need to be updated as market conditions change.[vii] Market conditions can include macroeconomic changes, such as interest rates or foreign-exchange rates, or asset-specific conditions such as oil prices (for oil-generating assets) or consumers' behavioral patterns for portfolios of consumer loans.

Shareholders' views are top-of-mind for most corporate managers, since their performance is often judged by how the stock performs, not to mention that their compensation often comes in the form of company shares, tying their own fortunes to the stock price.

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The management of publicly traded corporations, exposed to under-performing or non-performing assets, may not want to recognize a loss at an inopportune moment. What might begin as an innocent desire to simply stave off a write-down in anticipation of "fairer winds ahead" may become increasingly problematic if conditions worsen, rather than improve.

While some may "delay-and-pray" in the hope that a market turnaround can halt or reverse an under-performing assets' decline in value, other firms might postpone a negative announcement to join it with an imminent shareholder-friendly disclosure (for example, a corporate action), in the hope that investors will glance over the write-down in light of the accompanying positive news.

In the context of loan receivables, companies might be induced to adjust loan terms so as to make them temporarily *appear* to be more promising to shareholders. One option available is to re-write contracts for delinquent loans — to extend them or change the interest due — in such a way that the debtors are no longer technically delinquent on payments. This sometimes works, especially when debtors only need some leeway before coming current again. However, in many instances this is simply a conscious or unconscious manifestation of wishful thinking on the part of the asset owner, whose hopes of improved asset performance are tied to a market or economic rebound that does not come to fruition. A market slowdown can magnify or exacerbate the problem, with those who have extended their loans or delayed their write-downs being forced into a day of reckoning.

It is in this context of "delay and pray" that Warren Buffett is regularly quoted as saying: "you only find out who is swimming naked when the tide goes out." Some illustrative examples follow:

- Yorkville Advisors: In 2012, the SEC charged Yorkville Advisors (roughly $1 billion AUM at its peak) with fraud concerning the firm's valuations. According to the SEC, Yorkville failed to follow its stated valuation policies for its illiquid assets and failed to mark down its valuations as appropriate. The SEC determined that it found "a scheme to inflate fees by grossly overvaluing fund assets."[viii]

- Platinum Partners: The DOJ and SEC brought a case against the hedge fund Platinum Partners (approximately $1.7 billion AUM at its peak) for the fraudulent valuations associated with the fund's illiquid assets, most notably certain oil holdings. According to the SEC, Platinum terminated the auditor that had in 2014 identified "material weakness" in Platinum's valuation process and "a 'very material' misstatement that required a large markdown…."[ix] The hedge fund has filed for bankruptcy protection and is in liquidation. It estimates that final distributions to investors will amount to only 10% of the previously stated NAV. Six Platinum executives have been arrested and charged with, inter alia, securities fraud and investment advisor fraud.

- KCAP Financial: In November 2012, KCAP Financial settled SEC allegations that it failed to properly value CLO positions during the financial crisis, maintaining its two largest CLO holdings at their amortized cost price, instead of incorporating market prices for a fair value calculation. Problematically, the company had stated in public filings that it valued the assets using a discounted cash flow method. Three of the company's executives were fined small amounts, neither admitting to nor denying the SEC's allegations.

- ExxonMobil: Oil prices began to drop sharply in the summer of 2014, with spot prices and front-month futures contracts falling approximately 80% over the subsequent 19 months, before rebounding modestly (relative to 2014 levels) from February 2016 through May 2017. Over that time, most major oil and gas exploration and production companies wrote down the value of their oil assets, with total write-downs amounting to roughly

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$50 billion.[x] One exception had been ExxonMobil, which left its valuations unchanged despite the dramatic decline in oil prices. News reports in September 2016 indicated that the SEC was investigating ExxonMobil's valuation practices (as well as a climate-change disclosure investigation). In February 2017, 6 months to 15 months after its competitors' oil price-driven write-downs, the company disclosed write-downs on some of its assets, particularly its oil sands assets.

- Serageldin / Credit Suisse: During the financial crisis, Kareem Serageldin, the then Global Head of Structured Credit Trading at Credit Suisse, instructed his subordinates to manually override RMBS and CMBS marks provided by 3rd-party pricing service Financial Times Interactive Data (FTID), in order to stave off loss recognition. Eventually, in March 2008, Credit Suisse recognized $540 million in losses on Serageldin's trading book, as part of a broader $2.7 billion ABS write-down. In 2013 Serageldin pleaded guilty and was sentenced to 30 months in prison, making him possibly the most senior Wall Street executive to serve a prison sentence for financial crisis-era misconduct.

- Zhou / Deutsche Bank: In 2016, a Deutsche Bank trader, Tianyu Zhou, settled SEC charges that he mismarked CMBS positions. The SEC found that Zhou misled Deutsche Bank's Valuation Group by knowingly submitting false coupon data, boosting valuations and thereby overstating his trading book's profits by about 50%. Zhou was fined $50,000 and barred from the securities industry for at least three years. Zhou neither admitted to nor or denied the SEC's allegations

- The London Whale: In 2012, Bruno Iksil, a trader in JPMorgan Chase's (JPM) Chief Investment Office (CIO), accumulated CDS positions in the CIO's Synthetic Credit Portfolio (SCP) that were so large that he ultimately became known as the "London Whale."

  As the positions moved against him, Iksil continued to add to them, compounding the losses. According to a subsequent report examining the losses,[xi] Iksil's positions had breached value-at-risk (VaR) limits, but after repeated breaches, JPM implemented "a new, 'improved' VaR model for [the firm's Chief Investment Office]."

  In addition to JPM changing the VaR methodology, a CIO trading assistant (Javier Martin-Artajo) allegedly used overly aggressive position marks in an effort to minimize stated trading losses.[xii] Instead of marking positions at the mid-price, Martin-Artajo allegedly tried to disguise losses by marking positions at the most aggressive point along the bid-ask spread, even sometimes applying levels outside the bid-ask spread. It is possible that Iksil and his team thought that they could delay recognizing the worst of their losses, "buying time" to unwind the positions into a more hospitable market.

  Other divisions at JPM, such as the Investment Bank, also held positions in some of the same instruments, but valuation discrepancies between the CIO and the Investment Bank were not reconciled, even after being brought to the attention of senior managers. In July 2012, JPM would restate its 1Q12 financial statements to revise its earnings down by $459 million, saying:

  > *"… the firm has recently discovered information that raises questions about the integrity of the trader marks and suggests that certain individuals may have been seeking to avoid showing the full amount of the losses in the portfolio during the first quarter. As a result, we are no longer confident that the trader marks reflected good faith estimates of fair value at quarter end and we decided to remark the positions utilizing external 'mid-market' benchmarks…."*[xiii]

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It would eventually cost the bank $6.2 billion to unwind Iksil's losing positions, and JPM would pay regulatory fines, amounting to $920 million. According to an administrative proceeding filed by the SEC, JPMorgan's "actual price-testing methodology employed by [the CIO's Valuation Control Group] in the first quarter of 2012 was subjective and insufficiently independent from the SCP traders, which enabled the traders to improperly influence the [Valuation Control Group's] process."[xiv]

Issues with Broker/Market Quotes

- U-Turn Quotes: In June 2016, the DOJ and SEC charged Visium Asset Management (roughly $8 billion AUM at its peak) for valuation issues, stemming from the fund's usage of sham "U-turn" quotes to mark certain positions.[xv] A portfolio manager or trader obtains a U-turn quote by telling a friendly broker the exact level at which he would like a security to be quoted, and the broker then sends that price back to the portfolio manager as if it were a bona fide quote or indication. In June 2016, a Visium portfolio manager pleaded guilty to mismarking securities at month-end and year-end on hundreds of occasions by obtaining "U-turn" quotes from friendly dealers and using those quotes to override independent third-party valuations (in order to increase the positions' marks). According to the SEC, the mismarking yielded Visium an additional $6 million in fees. The firm is now winding down or selling its funds and assets.

  In a separate, developing matter, as part of the trial against former Nomura MBS traders, a cooperating witness testified in May 2017 that, in addition to lying to his trading customers about bond prices, he also provided some of them with U-turned quotes. The witness testified that he "would extend marks to make them seem like they were my own."[xvi]

  In an earlier case involving sham broker quotes, former Millennium Global Emerging Credit Fund portfolio manager Michael Balboa was convicted of fraud.[xvii] Balboa was found to have orchestrated a scheme in which he gave a former BCP Securities broker phony marks for two of his illiquid positions (warrants for Nigerian and Uruguayan debt). The broker then submitted the marks to Millennium's independent valuation agent and outside auditor, as if the marks were independent and objective. According to the SEC, "By overstating the Fund's returns and overall net asset value, Balboa was able to attract at least $410 million in new investments, deter about $230 million in eligible redemptions and generate millions of dollars in inflated management and performance fees."[xviii]

- Saba Capital / Unreliable Market Quotes: Public Sector Pension Investment Board ("PSP"), a Canadian pension fund, alleged in its September 2015 complaint against Saba Capital Management (peak AUM: $5 billion) that Saba had altered its valuation methodology for one issuer's corporate bonds (those of The McClatchy Company) just before fulfilling the pension fund's redemption request, in order to suppress the bonds' valuations. PSP argues that Saba changed its methodology to an all-or-none bids-wanted-in-competition, or BWIC, and then resumed its prior valuation methodology after the redemption was complete, marking the bonds back up.
  Transcripts of several chats between the hedge fund and external quote providers illustrate the degree to which the pricing process can be an art form (or based on relationships), rather than a scientific inquiry.

  > *Saba Capital's Weinstein*: Z, where would you bid a few mm of the 29s with or without 5yr cds? ...
  > *Trader*: most likely below where you care. 50- 2mm

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Weinstein: Yes, that is low I think.
Trader: where would u bid?
Weinstein: Who knows. See it quoted much higher. Actually you should change your 65/66 quote I guess.
Trader: im happy to reflect any market you would like me to make
Trader: i have no position
Trader: and quote it only
Trader: but thats the discount i would bid to go at risk
Weinstein: Yeah, the quote seems wrong I guess.
Trader: given how illiquid it is
Trader: sure do u have a two sided market?
Trader: or what is an appropriate quote?
Weinstein: I guess if you only care at 50 on 2mm then probably 65/ for any size is wrong.

The Mis-Valuing of Odd-Lots

"Odd lots" are small or uneven amounts of an issue, say, less than $1 million, although there is no set threshold and it would vary by bond type. Because bond trading is dominated by dealers and institutional customers trading in large blocks, odd lots typically trade at a discount to round lots, reflecting the decrease in demand.

In December 2016, the SEC fined PIMCO $20 million for what the SEC claimed was the habitual marking up of *odd lots*, in PIMCO's BOND fund, to its third-party vendor's *round-lot* price. BOND is an ETF form ($2.2 billion AUM) of its well-known Total Return Fund ($74.6 billion AUM, down from a peak of $293 billion in 2013), previously managed by Bill Gross.

According to the SEC:

> "… on March 9, 2012, PIMCO purchased an NA MBS odd lot at $64.9999 with a current face of $0.2 million. PIMCO then valued the position at the Pricing Vendor's institutional round lot mark of $82.74585 (a 27% increase). This trade alone increased BOND's NAV by nearly $0.02 per share in one day."[xix]

Window Dressing

In the examples we provide here, the issues of discretion are more implicit, manifesting themselves in risk-related aspects, instead of explicit pricing mechanisms.

The SEC is mining data to track individual bonds across dealers' balance sheets to detect "bond parking." Bond parking occurs when *Party A* sells a bond to *Party B*, with the understanding that *Party B* will sell the bond back to *Party A* shortly thereafter, perhaps after a period-end (generally at a slightly higher price, to compensate the party holding the asset on its balance sheet at period-end). The purpose of the arrangement is to allow *Party A* to temporarily reduce the size of its trading book or "aged-inventory," thereby temporarily skirting its risk limits at a discrete measurement date.

- <u>Barclays / Gleacher</u>: In February 2014, the SEC alleged that traders at Barclays and Gleacher & Co. conspired in a bond parking scheme.[xx] According to the SEC, Thomas Gonnella, a former Barclays trader, sold bonds to Gleacher in order to reset the holding periods on the bonds, gaming the firm's aged-inventory policy. On May 31, 2011, Gonnella wrote to Ryan King at Gleacher (via instant message):

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> “i have 4 small bonds that i’m looking to turnover today for good ol’ month end/aging purposes ... i like these bonds ... and would more than likely have a higher bid for these later this wk when the calendar turns ...”

On August 29, 2011, Gonnella wrote:

> “let’s talk tmrw. Have some aged bonds that I might offer you, if you’re game ... maybe do what we did a few months ago w/ some of those bayc’s ...”

- Morgan Stanley / Société Générale: In December 2015, Morgan Stanley Investment Management (MSIM) and SocGen settled SEC allegation of bond parking, paying a combined $10 million.[xxi] The parties neither admitted nor denied the SEC’s findings. The SEC alleged that SocGen parked bonds on behalf of MSIM on six occasions, spanning 81 different fixed-income positions, with MSIM repurchasing the bonds the following day. MSIM’s portfolio manager/trader allegedly moved positions from one fund to another, and instead of executing a cross-trade at the mid-price per company policy, he allegedly engaged SocGen to assist in the pre-arranged trading, in an effort to avoid losses in one MSIM fund to the detriment of another.

- Lehman Brothers’ Infamous Repo 105 Trade: Repo financing is widely used by many firms, and as such constitutes a major part of the plumbing of the modern financial system. Leading up to its demise, Lehman Brothers made a habit of entering repurchase agreements (“repos”) to temporarily move risky assets off its balance sheet just prior to quarter-ends, in order to lower its reported leverage. Repos are typically accounted for as secured borrowings, rather than as sales, however Lehman put up collateral worth 105% of the funds it received so that, from an accounting perspective, it could treat those repos as sales. This accounting gimmick reduced the size of the investment bank’s risky holdings, thereby improving its capital ratios and presenting a comparatively rosy picture to investors in its quarterly reports. At the end of the second quarter of 2008 — the last full quarter before Lehman filed for bankruptcy in September 2008 — Lehman utilized Repo 105 to move $50 billion in assets off balance sheet. The Financial Accounting Standards Board (FASB) changed its rules in 2011 and 2013 to close the accounting loophole that allowed Lehman’s repo borrowing to be classified as sales.

- Deutsche Bank’ Leveraged Super Senior (LSS) Trades: During the financial crisis, Deutsche Bank had a $120 billion portfolio of LSS positions, with the bank having purchased credit protection from various CDS sellers. According to the SEC, some collateral was posted by the protection sellers, but only about 9% of the notional amount involved was covered by posted collateral. As credit markets deteriorated and the CDS positions moved in Deutsche Bank’s favor, the trades’ profits exceeded the amount of collateral posted. Banks are supposed to account for this so-called “gap risk” when they value this type of asset. Instead, Deutsche Bank altered its gap risk methodology to decrease its stated gap risk, and treated its credit protection as if it were fully collateralized, in turn increasing the overall value of the LSS portfolio. By understating “gap risk” (by $1.5 billion, according to an outside expert hired by the SEC) and overvaluing the LSS portfolio, Deutsche Bank was able to increase its earnings and profitability, particularly important during this chaotic time for large banks. In 2015, Deutsche Bank settled with the SEC, paying $55 million.[xxii]

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[i] https://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0701-AIG-Goldman-supporting-docs.pdf

[ii] Under the European Union's newly-introduced MiFID II framework, post-trade transparency is expected to improve dramatically for issues falling within the directive.

[iii] https://www.sec.gov/about/offices/ocie/letter-presence-exams.pdf

[iv] An asset manager may want to temporarily lower prices for a variety of reasons, but these are sometimes idiosyncratic and beyond the scope of this report. One of the more typical reasons for actively lowering prices (and delay gain recognition) is seen in the smoothing of revenues or earnings: in the asset management business, managers are not solely judged by their vanilla performance returns, but based on the amount of risk they took to achieve those returns - their risk-adjusted returns. As such, the smoothness of returns can affect a key performance measurement known as the Sharpe ratio, which measures a portfolio's return (in excess of the risk-free rate) divided by volatility. An asset manager may be tempted to smooth out the volatility of returns, thereby artificially lowering the measure of volatility, and increasing the portfolio's Sharpe ratio.

[v] Brokers are generally not required to meet their *indicative* quotes.

[vi] Asset management companies normally have policies and procedures in place to prevent misconduct, to the assurance of outside investors, but problems ensue when those policies are either intentionally or unwittingly ignored.

[vii] Not all assets or investments need to be re-adjusted. Some may be held, for example, on an amortized-cost basis. This section deals with assets that need to be reassessed in accordance with a company's accounting guidelines, for example tradeable assets that need to be marked to in accordance with FASB's guidance for the measurement of "fair value" under Topic 820.

[viii] https://www.sec.gov/news/press-release/2012-2012-209htm

[ix] https://www.sec.gov/litigation/complaints/2016/comp-pr2016-267.pdf

[x] https://www.wsj.com/articles/sec-investigating-exxon-on-valuing-of-assets-accounting-practices-1474393593

[xi] http://files.shareholder.com/downloads/ONE/2272984969x0x628656/4cb574a0-0bf5-4728-9582-625e4519b5ab/Task_Force_Report.pdf

[xii] https://www.justice.gov/sites/default/files/usao-sdny/legacy/2015/03/25/U.S.%20v.%20Javier%20Martin-Artajo%20Complaint.pdf

[xiii] https://www.sec.gov/Archives/edgar/data/19617/000119312512301391/d379832dex991.htm

[xiv] https://www.sec.gov/litigation/admin/2013/34-70458.pdf

[xv] https://www.justice.gov/usao-sdny/pr/former-portfolio-manager-stefan-lumiere-convicted-all-counts-manhattan-federal-court

[xvi] https://www.bloomberg.com/news/articles/2017-05-11/hedge-funds-facing-u-s-criminal-probe-over-bond-valuations

[xvii] https://www.justice.gov/usao-sdny/pr/hedge-fund-portfolio-manager-convicted-manhattan-federal-court-scheme-inflate-value

[xviii] https://www.sec.gov/litigation/litreleases/2011/lr22176.htm

[xix] https://www.sec.gov/litigation/admin/2016/ia-4577.pdf

[xx] https://www.sec.gov/news/press-release/2014-24

[xxi] https://www.sec.gov/news/pressrelease/2015-287.html

[xxii] https://www.sec.gov/news/pressrelease/2015-99.html

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