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Illiquid Asset Valuation Presents Unique Risks Amid Pandemic

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Even in stable market conditions, the process of valuing illiquid assets is commonly described as being as much art as science. And just as in art, where beauty is in the eye of the beholder, in valuation, the price can be higher or lower based on the perspective of the party conducting the valuation.

Stephen Ascher

Market turmoil, such as that created by the COVID-19 pandemic, inevitably increases the opportunities for divergent valuations. Because illiquid assets by their nature do not have well-established prices based on regular market transactions, participants in a transaction can readily disagree on the true value of a given financial instrument.

When financial markets seize up, it is even more difficult to obtain usable market pricing for illiquid securities, forcing parties to rely on subjective methodologies that are vulnerable to misjudgment or even abuse.

Charles Riely

At the same time, in choppy financial markets, parties may be considering, or faced with, redemption requests, margin calls and forced sales — business pressures that greatly intensify the incentives to take extreme positions, and that translate otherwise abstract valuation questions into practical business issues that require payment of cash on the barrel.

As a helpful reminder of the importance of valuation, on Dec. 3, 2020, the U.S. Securities and Exchange Commission adopted new Rules 2a-5 and 31a-4 under the Investment Company Act that require investment advisers to adopt enhanced policies and procedures for ensuring that their valuations properly reflect the fair value of their assets.[1]

Andrew Lichtman

These new rules require fund advisers to assess risks associated with fair value determinations, to test the appropriateness of the valuation methodology used, and to oversee pricing services used during the valuation. Though limited to investment advisers, the SEC's new rules signal that valuation issues, which were at the core of litigation arising out of the 2008 financial crisis, will assume renewed importance in the months ahead.

Given the continued importance of these issues, this article outlines the key concepts of valuation and discusses how these cases have played out in a variety of contexts.

Valuation Concepts

The fundamental objective of the valuation process is to determine the fair value of the asset, which is typically defined as the price that would be received to sell the asset, or paid to transfer a liability, in an orderly transaction between willing market participants at the measurement date.

Importantly, the process of determining fair value varies greatly depending on the liquidity of the security in question.[2] Some assets are easy to value because they are regularly bought and sold at knowable prices — these are called Level 1 assets. Level 1 assets include the most liquid and easily priced assets of all — securities traded and listed on the major exchanges — but also assets such as foreign currencies, Treasury bills and commodities.

Some of these assets have prices published on an exchange; others also have easy-to-obtain market prices through readily available services such as Bloomberg. Parties do not typically dispute the prices of Level 1 assets.

At the other end of the spectrum are assets that are so rarely traded and so complex, there are no market prices available for them. These assets, known as Level 3 assets, must be valued using mathematical models that include subjective assumptions about future events such as the risk of default. Level 3 assets include mortgage-backed securities, certain types of derivatives, private investments and distressed debt.

In between the two extremes of Level 1 and Level 3 assets are, naturally, Level 2 assets. Level 2 assets cannot be valued using the kinds of direct market pricing that is available for liquid securities, but they can be valued based on objective criteria, commonly known as observable inputs, such as quoted or trading prices for similar securities in an active market, or quoted prices for identical or similar securities in an inactive market.

As should be obvious, when it comes to Level 2 and Level 3 assets, the opportunities for disagreement are numerous. Some disputes have turned on a disagreement concerning the threshold question of whether an asset should be considered Level 1, 2 or 3 — which could result in the use of entirely different methodological approaches.

Even within Level 2 or Level 3, parties may disagree about which, if any, assets for which pricing is more readily available are comparable to the assets being valued, how different the valued assets are from those other assets, and what types of other subjective inputs or adjustments should be included in the analysis.

Needless to say, in a volatile market, the range of what would potentially be a reasonable assumption is necessarily far broader than in a stable market.

Valuation Disputes Since the Last Crisis

The 2008 financial crisis was at its heart a liquidity crisis — parties did not have enough cash available to enter into transactions. That in turn caused thinly traded securities to become even more rarely traded

— and the few transactions that did occur were arguably fire sales whose prices were not considered indicative of market prices. A wide variety of disputes occurred soon after the crisis, and up to the present.

SEC and Criminal Actions Against Fund Managers

A number of civil, regulatory and even criminal cases have arisen out of claims that hedge fund managers mispriced the value of certain fund assets in order to inflate the overall net asset value of the fund, which typically determines the compensation due to the adviser and its employees.

These actions are usually premised as securities fraud actions where the government or other plaintiff alleges that: (1) the hedge fund disclosed a rigorous process for ensuring that the relevant securities were valued at fair market; and (2) the hedge fund's employees then failed to apply the disclosed policy and mismarked securities.

One illustrative parallel criminal and regulatory action was the 2016 action against Visium Asset Management LP. In that case, Visium valued illiquid assets by using broker quotes that purportedly reflected the price at which independent brokers were holding the assets.

The key allegation was that the brokers were not in fact independent, but instead were coconspirators who received the desired prices from the Visium manager, and then parroted those prices back as purportedly independent quotes. The manager had also misrepresented to investors that the assets were Level 2 assets when in fact they were Level 3.

The manager was convicted of securities fraud and wire fraud.[3]

The recently enacted SEC rules enhance the likelihood of future SEC enforcement actions around valuation issues. Most importantly for our purposes, Rule 2a-5 sets forth specific requirements for determining the fair value of a fund's investments in good faith. Among other things, funds must:

- Periodically assess any material risks associated with the fair value of the fund's investments, including material conflicts of interest, and manage those identified risks;
- Select and apply fair value methodologies, including by (1) selecting and consistently applying appropriate fair value methodologies that are specific to each asset class or portfolio holding, (2) periodically reviewing the appropriateness and accuracy of the methodologies selected, and (3) monitoring for circumstances that may necessitate the use of fair value;
- Test fair value methodologies for appropriateness and accuracy; and
- Oversee and evaluate pricing services, including by establishing a process for approving, monitoring and evaluating each pricing service provider.

Funds will have 18 months after the effective date to comply with Rule 2a-5, meaning that we are likely to see a new wave of SEC enforcement actions beginning in the second half of 2022.

Civil Litigation With Respect to Margin and Collateral Calls

In the civil context, most valuation disputes have related to requests for collateral. For example, immediately before and during the 2008 crisis, Goldman Sachs & Co. issued a series of billion-dollar

collateral calls against American International Group Inc. and Lehman Brothers Holdings Inc. based on Goldman's conclusion that AIG's credit default swap obligations had lost much of their value. AIG believed Goldman was undervaluing the swaps.[4]

Similarly, in February 2008, a hedge fund sued Citibank alleging that its demands for additional collateral arising out of a collateralized debt obligation credit default swap agreement were based on unjustified valuations.[5] The fund posted the additional collateral, but claimed that it did so only because it was afraid that Citibank would seize its collateral if it did not. The court rejected the fund's argument and held that the fund had waived its right to challenge the calls by providing the additional collateral.[6]

At least one similar case has already been brought in the wake of the COVID-19 pandemic. In March 2020, two mortgage real estate investment trusts, AG MIT CMO LLC and MIT K LLC, sued Royal Bank of Canada after RBC marked down the value of the plaintiffs' assets and issued margin calls under the parties' repurchase agreements.[7]

The plaintiffs alleged that the valuations calculated by RBC were not true market values in light of the temporary dislocation in the market,[8] and that it would not be possible to sell the securities in a commercially reasonable manner as a result of the ongoing crisis.[9] The parties ultimately settled their dispute.

Bankruptcy and Voidable Transfers

Finally, bankruptcies, which inevitably proliferate during an economic crisis, often raise hotly contested valuation issues. For example, in a voidable transfer litigation, key questions are whether the transferred assets were properly valued in prebankruptcy transactions and whether the bankrupt entity was insolvent at the time a transfer was made.

During the last crisis, the Lehman bankruptcy led to major litigation over whether certain transfers were voidable, lasting for nearly 10 years after Lehman's collapse. One of the largest cases was between the Lehman estate and JPMorgan Chase & Co., where the estate sued seeking the return of $8.6 billion in collateral that it posted in the weeks leading up to its bankruptcy filing.[10]

The Lehman estate contended that the transactions were voidable because, among other reasons, Lehman was insolvent when the transactions occurred. After years of litigation, the parties settled in 2016 and 2017, with JPMorgan paying the Lehman estate approximately $2.2 billion.[11]

Although the government bailout saved AIG from bankruptcy, AIG was nevertheless embroiled in a major dispute in which its counterparty alleged that AIG was insolvent, and had accordingly suffered an event of default under interest rate swaps between them.[12] A key question in the lawsuit was whether AIG had properly valued its illiquid assets and liabilities in 2008.

Conclusion

In light of the continued vitality of the securitization markets, and the prevalence of other forms of illiquid assets, market participants should take care to ensure that their own valuation procedures are adequate, and they should be sensitive to the risk that their counterparties may produce biased valuations that require rigorous checking.

Although the pandemic has not yet led to the type of financial crisis that precipitated the post-2008 valuation disputes, these issues will likely be exposed when the tide next goes out.

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[1] See SEC, SEC Modernizes Framework for Fund Valuation Practices (Dec. 3, 2020), https://www.sec.gov/news/press-release/2020-302.

[2] See, e.g., Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 157, Fair Value Measurements ¶¶22-30 (Sept. 2006), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220130001; Financial Accounting Standards Board, Accounting Standards Codification 820.

[3] See DOJ, Former Visium Portfolio Manager Stefan Lumiere Sentenced To 18 Months In Prison Following Conviction At Trial For Securities Mismarking Scheme (June 14, 2017), https://www.justice.gov/usao-sdny/pr/former-visium-portfolio-manager-stefan-lumiere-sentenced-18-months-prison-following.

[4] See Jessica Dye, Goldman Defends Collateral Calls on AIG Swaps, Law360 (July 1, 2010), https://www.law360.com/articles/178531/goldman-defends-collateral-calls-on-aig-swaps.

[5] See VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A., 594 F. Supp. 2d 334 (S.D.N.Y. 2008), aff'd, 355 F. App'x 507 (2d Cir. 2009).

[6] Id. at 342.

[7] AG MIT CMO, LLC v. RBC (Barbados) Trading Corp., No. 20-cv-2547 (S.D.N.Y. filed Mar. 25, 2020).

[8] Complaint ¶ 37.

[9] Id. ¶¶ 41-42.

[10] See Mike Spector & Susanne Craig, Lehman's Bankruptcy Estate Sues J.P. Morgan, Wall St. J. (May 27, 2010), https://www.wsj.com/articles/SB10001424052748704032704575268843657457202.

[11] See Johnathan Stempel, JPMorgan to Pay Lehman $797.5 million to End Litigation Over Collapse, Reuters (Feb. 1, 2017), https://www.reuters.com/article/us-jpmorgan-leh-bro-hldg-lawsuit/jpmorgan-to-pay-lehman-797-5-million-to-end-litigation-over-collapse-idUSKBN15G5T1 (reporting $797 million settlement in 2017, after $1.42 billion settlement in 2016).

[12] See Brookfield Asset Mgmt., Inc. v. AIG Fin. Prods. Corp., No. 09-civ-8285, 2010 WL 3910590, at *1 (S.D.N.Y. Sept. 29, 2010).