

MEMO# 25979

March 13, 2012

SEC Staff Inquiry On Level 2 Security Valuation Process

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TO: ACCOUNTING/TREASURERS COMMITTEE No. 7-12
CHIEF COMPLIANCE OFFICER COMMITTEE No. 4-12
END OF DAY PRICING FORUM No. 3-12
SEC RULES COMMITTEE No. 18-12
SMALL FUNDS COMMITTEE No. 8-12 RE: SEC STAFF INQUIRY ON LEVEL 2 SECURITY VALUATION PROCESS

We understand that accounting staff in the SEC's Division of Investment Management has recently contacted a number of different fund sponsors and asked a series of questions relating to valuation of securities classified within Level 2 of FASB's fair value hierarchy. The questions generally address how the fund sponsor determines that the models, inputs and assumptions used by third party pricing vendors are appropriate and consistent with GAAP. The questions are consistent with recent SEC staff remarks at conferences. [\[1\]](#)

We understand that the questions are provided to the fund sponsor in writing, and that the sponsor is asked to respond in writing within thirty days. We have not obtained the questions, however, based on discussions, they are described below.

Level 2 Valuation Questions

Third Party Vendor [General]

1. Do you obtain an independent auditor's report or SAS 70 from your pricing service?
2. Does it cover the entity's controls over valuation that you classify as Level 2?
3. Do you perform due diligence on the vendor or do you have them present to the board on its policies, procedures and controls?
4. How often does the diligence occur and is it performed on a regular basis?
5. Has the vendor ever reported to you that they had control deficiencies?

- a. If yes, what are these deficiencies? Please describe.
- b. How were these deficiencies considered in concluding that your valuation complied with GAAP and that there were effective Internal Controls over Financial Reporting to prevent a material error?

Vendor Prices and Data Obtained

1. Do you have policies and procedures that check the accuracy and reasonableness of data obtained on daily basis?
 - a. If yes, what are the policies and procedures?
2. What controls are in place to ensure that valuations determined by the third party are using models, assumptions, and inputs that would be utilized by a market participant?
3. Does the third party pricing service provide you a list of observable market data (including similar securities whose prices they use or adjust) or model inputs that they use to price each security or class of securities in sufficient detail that you are able to assess whether their pricing methodology complies with ASC 820?
 - a. If yes, explain how you validate the data or describe the procedures used to confirm the data's completeness and accuracy.
4. Does any documentation from the third party service provider contain disclaimers about the pricing information provided?
 - a. If yes, what procedures are performed to determine valuations are in compliance with GAAP and management has effective Internal Controls over Financial Reporting?

Price Challenge Process

1. Does your firm have a price challenge process with the third party vendor or broker?
2. Please describe the frequency with which prices are challenged for any particular level 2 security received from the service provider.
3. What were the results of such challenges? Do prices or valuations change? What frequency do they change?
4. What is the impact of these challenges on your assessment of the provider's internal controls?

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endnotes

[1] See [Remarks before the AICPA National Conference on Current SEC and PCAOB Developments](#) by Jason K. Plourde, Accounting Fellow, Office of the Chief Accountant (December 5, 2011).

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