Proskauer

Asset Manager Considerations After SEC's Pricing Data Case

Law360 on **February 16, 2021**

The U.S. Securities and Exchange Commission settled a novel enforcement action against ICE Data Pricing & Reference Data LLC in December 2020.[1] ICE is a pricing service that supplies data to investment managers.

Although the SEC alleged only violations of the compliance rule under the Investment Advisers Act, the action is a reminder to all investment advisers to be vigilant in their oversight of vendors of critical services to protect their own clients. It's also a reminder that long-running practices can be problematic.

Background

Pricing services are a critical part of the infrastructure of the asset management industry, helping money managers value less liquid securities. Nowhere are they more important than for mutual funds, which have an obligation to accurately determine the value of their portfolios each day and compute a price at which their shares will be sold and redeemed.

A small inaccuracy can result in significant wealth transfers between buyers and sellers of fund shares. Pricing services are particularly important in helping fund managers determine the fair value of bonds and other fixed income investments, which often trade infrequently in fragmented markets. A small number of pricing services dominate the market.

The administrative proceeding brought by the SEC against ICE alleged violations of Section 206(4) and Rule 206(4)-7 — or the compliance rule— under the Advisers Act. The SEC action involved ICE's pricing services for bonds and other fixed income securities provided to money managers, among others.

The complexities of the bond market make it difficult to price fixed income securities in a way that accurately reflects their economic value. Trade information may not reflect the underlying value of bonds, which may be affected by a number of factors, including economic conditions, unreported trades, interest rates, credit risks and the amount of time that has passed since an actual trade.

ICE, like many pricing services, offers evaluated prices based on analysis of a variety of market data points, including "benchmark yields, reported trades, bids, offers, and two-way markets."

The SEC's Allegations

The SEC alleged that from 2015 through 2020, instead of seeking multiple data points, ICE relied upon a single broker quote to determine the prices of certain fixed income securities.

The agency observed that clients of ICE would have found it very difficult to ascertain whether the marks they received were based on a single broker quote or were evaluated by ICE, and thus may have relied on less accurate prices in order to value their portfolios or make trading decisions.

It also noted that ICE charged its clients the same fee for single broker quotes as it did for evaluated prices. In September 2020, ICE discontinued its provision of single broker-quoted prices.

As noted above, the SEC alleged violations of the Advisers Act. ICE's valuation activities made it an investment adviser subject to the Advisers Act. Section 202(a)(11) defines the term "investment adviser" to include those who provide traditional advice about securities, as well as those who give advice about the value of securities.

As an adviser, a pricing service has a fiduciary obligation to its clients who use its services, which includes the duty of care about the advice it provides and a duty to avoid misleading clients. These obligations were discussed in detail in a 2019 interpretive release [2] issued by the SEC.

The SEC did not find violations of ICE's fiduciary obligations to its clients. Instead, the agency asserted that ICE failed to develop written compliance policies and procedures that addressed the reliability of single broker quotes. The SEC alleged that, as a result, ICE delivered to clients certain price quotes that may not have been "a reasonable reflection of the security's value."

The SEC found that, although ICE disclosed the risk that single-broker quotes were less reliable, clients would have found it very difficult to determine (1) which prices were the product of a single broker quote, and (2) the age of the quote.

Moreover, ICE did not have in place adequate policies and procedures to address the reliability of broker quotes based upon the aging of the quotes, other market events or frequent client challenges.

Finally, the SEC found that ICE failed to adopt and implement policies and procedures to prevent it from using quotes from brokers in circumstances where the quotes gave doubt about their accuracy, including quotes that remained unchanged for 18 months and those that were unusually volatile.

By settling with ICE for a violation of the compliance rule, the SEC avoided having to demonstrate that the price quotes ICE provided to its client were inaccurate. This would have been a difficult lift for the SEC and would likely have required it to engage another pricing service as an expert to help demonstrate what the correct evaluated prices should have been.

Pricing is not a science; it involves opinions based upon significant judgments. As a result, any prices provided by other pricing services on behalf of the SEC would have been subject to dispute by ICE.

The settlement for a compliance rule violation also avoided questioning the accuracy of prices at which the asset managers may have valued client portfolios based on ICE-provided quotes during the 2015-2020 period at issue in the enforcement action. In this respect the SEC may have done asset managers a favor.

Settlement

In settlement, the SEC found violations of the compliance rule. ICE was ordered to pay an $8 million civil monetary penalty and to cease-and-desist from committing or causing any future violations of the compliance rule.

Lessons Learned for Asset Managers

The SEC enforcement action is a reminder to asset managers of their own obligations to exercise care to protect clients from the consequence of errors made by pricing services on which they rely. Such errors can affect trading decisions, asset management fees, fund performance used in marketing material, and compliance with various contractual and regulatory requirements.

All advisers have a duty of care with respect to the selection and oversight of the pricing services they use. As the enforcement action reminds us, they too need to implement compliance policies and procedures that reflect their fiduciary duties.[3]

These are not new obligations and their satisfaction ordinarily would not require the adoption of unfamiliar practices. Many, if not most, money managers will challenge price quotes that seem incorrect, compare marks from pricing service with the prices of observed transactions and employ a secondary pricing service to check marks receive from their primary pricing service.

A strong compliance program will require the adviser to periodically review its use of a pricing service and make adjustments based upon the quality of services they have received and any new entrants into the market for pricing services that may offer greater expertise than incumbents.

The boards of directors of registered investment companies bear a specific statutory responsibility for determining the fair value of illiquid fund investments.[4] Under a rule recently amended by the SEC, fund boards must oversee pricing service providers and establish "a process for approving, monitoring and evaluating each pricing service provider and initiating price challenges as appropriate."[5]

Although this rule is not yet in effect, this obligation is not substantially different from the SEC's view of fund boards' existing obligations.[6]

In satisfying these obligations, a fund board should assure itself that the fund's adviser and any pricing committee review the quality of marks received from pricing services. As the SEC's findings in this enforcement action illustrates, fund boards and advisers cannot simply rely on the pricing services to police themselves.

[1] https://www.sec.gov/litigation/admin/2020/ia-5643.pdf.

[2] https://www.sec.gov/rules/interp/2019/ia-5248.pdf.

[3] See Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Rel. No. 2204 (Dec. 17, 2003) (adopting Rule 206(4)-7 under the Advisers Act) (an adviser compliance policies and procedures should establish processes to value client holdings).

[4] Section 2(a)(41)(A) (defining "value").

[5] Rule 2a-5(a)(4), as amended. When it amended the rule, the SEC set forth a number of specific factors the board should consider before deciding to use a pricing service. Good Faith Determinations of Fair Value, Investment Company Act Rel. No. 34128 (Dec. 3, 2020) at

[6] Money Market Fund Reform; Amendments to Form PF, Investment Company Act No. 3879 (July 23, 2014) at 227.

Related Professionals

- **Hena M. Vora**
  Associate