SEC continues to focus on “fair value” practices of investment advisers

Private Equity Alert

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The media has been shining a strong spotlight on SEC insider trading cases, but in recent years, with much less fanfare, the SEC has brought nearly three times as many cases against investment advisers.

Between 2009 and 2013, the number of enforcement cases against investment advisers nearly doubled. Over the last two years, they accounted for the largest single segment of cases brought by the SEC.

These trends show no signs of abating. As Bruce Karpati, the former head of the SEC Enforcement Division’s Asset Management Unit (AMU), warned earlier this year at a private equity forum, “It's not unreasonable to think that the number of cases involving private equity will increase,”[1] and similar developments can also be seen in other areas within the alternative investment funds space.

The AMU is one of the “specialized units” created as part of the Enforcement Division’s post-Madoff reorganization. Its central focus is on hedge funds, private equity funds and investment advisers to alternative investments. The AMU has hired industry specialists, including equity analysts and former industry professionals at hedge funds and due diligence firms, to more effectively spot potential cases and better understand the industry. According to Mr. Karpati, these industry professionals have been successful in uncovering issues that the SEC may not have identified otherwise.

Trends in SEC cases against investment advisers

In the past three years alone, the SEC has brought more than 100 enforcement actions against alternative investment fund managers. A significant majority of these cases involved:

- Conflicts of interest
- Valuation
- Performance
- Compliance and controls

Mr. Karpati attributed seven of the hedge fund related enforcement actions to the SEC’s previously announced “Aberrational Performance Inquiry.” Under this Inquiry, the Division of Risk, Strategy, and Financial Innovation (RiskFin) [2] and the Office of Compliance Inspections and Examinations (OCIE) analyze performance data of thousands of hedge fund advisers and refer suspicious candidates for examination or investigation. According to Karpati, this initiative is continuing, and “is now focused on a subset of hedge fund strategies that have a high incidence of suspicious returns.” [3]

Valuation issues

Throughout 2012 and into 2013, in addition to focusing on returns, the SEC repeatedly signaled that it was also focusing on valuations, including valuations of complex and illiquid investments. In addition, the SEC warned the industry that it was focusing on the potential overvaluation of assets during the fund marketing stage. Because investors and potential investors often question the valuations of active holdings, the SEC indicated it was concerned that managers were exaggerating the performance or quality of these holdings by writing up the assets during a fund-raising period and then writing them down after the period closes.

These signals came to fruition with a burst of enforcement actions in late 2012 and early 2013. Since October 2012, the SEC has filed at least five cases in which it alleged false or fraudulent fund valuations (including one analogous case against a mutual fund and its board of directors).[4] (See sidebar for list of common valuation issues raised by the SEC.)

Common valuation issues raised by the SEC

Below are some of the most common valuation issues raised by recent SEC enforcement cases:

- Fixed-income securities were appraised at face value rather than based on current, market prices available on the measurement date.
- Interest paid in-kind increased the carrying value of distressed debt in circumstances where recovery of principal and interest was unlikely.
- The value of underlying collateral for a portfolio investment was misrepresented.
- Asset–backed securities and structured products were valued based on models developed by management that did not adequately incorporate market-based inputs available on the measurement date (typically discount, prepayment and default rates).
- Valuations of illiquid investments were provided by consultants that were affiliated with a fund and relied on inputs obtained from the fund's portfolio managers, which resulted in valuation overstatements.
- Private equity investments were valued at cost, and an adequate fair value analysis to determine whether cost approximated fair value wasn't performed.
- When investments were valued using the discounted cash flow model, future estimated proceeds were not discounted to present value.
- Valuations of debt securities did not take into account the effect of significant corporate events, such as a bankruptcy proceeding.
- Valuations were based on stale data and were not updated frequently enough to be a suitable representation of then-current market conditions.
- Valuation methodologies for illiquid investments were misrepresented in the fund's marketing materials.

In addition, the SEC has brought actions against investment advisers for violating their own existing valuation policies and procedures in areas such as:

- Frequency of valuation meetings
- Documentation of valuation decisions
- Use of third-party specialists to provide independent valuations and/or support management's estimates
- Price override procedures
- Resolution of price challenges
- For fund-of-funds investments, valuations based on management's estimates even though the fund's policy specifically required the use of net asset value as reported by the investee entity

Board of Directors' valuation responsibilities

The SEC has also focused on the board of directors' responsibilities in (1) monitoring the valuation process and methodologies applicable to portfolio investments, and (2) determining the fair value for individual securities. While the SEC cases in this area have concentrated on registered investment companies (RICs), the issues identified by the SEC for RICs also apply to alternative investment funds.

In December 2012, for instance, the SEC charged eight former mutual funds directors with violating their responsibilities in the fair valuation of portfolio securities for which market prices were not readily available. According to the SEC, the directors:

- Did not specify a fair valuation methodology to use in valuing the securities,
- Failed to continuously review the appropriateness of the method to be used in valuing each issue of a security in the company's portfolio,
- Delegated their responsibility to determine fair value to a valuation committee, but did not provide any meaningful, substantive guidance on how those determinations should be made,
- Made no meaningful effort to learn how fair values were actually being determined,
- Received only limited information on the factors considered in making fair value determinations, and
- Received almost no information explaining why particular fair values were assigned to portfolio securities.

Ultimately, the SEC charged the mutual funds with materially misstating their net asset values for at least a five-month period in 2007 and maintained that the board of directors should be held accountable for failing to fulfill its valuation responsibilities.

Other areas of SEC focus

In addition to valuation, hedge funds, private equity and other participants in the alternative investment space can expect the SEC to focus on:

- The AMU's recently announced Private Equity Initiative, which aims to identify private equity fund advisers that are at higher risk for certain specific fraudulent behavior
- Hedge funds that are "retail oriented; in other words, funds that "ordinary investors," tend to purchase, either directly or indirectly, through pensions, endowments, foundations and other retirement plans) and
- Smaller, unregistered investment advisers that may not have adequate compliance policies in place and may also pose a risk of fraud to the investing public.

What's more, the SEC may have already telegraphed its concern with respect to a type of private equity fund referred to as "zombie funds." Zombie funds allegedly delay liquidity of their holdings or misrepresent the value of their assets because income from those assets is their only source of revenue.

While having a zombie fund, or being a zombie fund manager, is not in and of itself unlawful, Karpati noted that "the zombie manager issue is significant, and given the large amount of capital raised in 2006 and 2007, will likely become more important when those vintages reach maturity."

Action steps for fund managers

In a recent speech, SEC Commissioner Luis Aguilar discussed the SEC's recent activities and advised individuals with compliance responsibilities to pay close attention to their firm's valuation processes, adding that "an ounce of prevention will be worth a pound of cure."[5] He also pointed out that the SEC has requested 250 additional examiners in its proposed budget "to more quickly examine newly-registered entities whose activities may pose greater risks."

Given the SEC's continuing focus on valuation – and on investment advisers to alternative investment funds (and potentially, the SEC's additional resources) – fund managers should consider doing the following:

Establish and/or implement an adequate compliance function: In the wake of Dodd-Frank, over 1,500 new investment advisers recently registered with the SEC. In response, the SEC has exhorted these advisers to institute and maintain adequate compliance measures or face sanctions if they do not.

For example, in January 2013 the SEC charged an investment adviser with failing to adopt and implement written compliance policies and procedures, and not conducting annual compliance reviews. According to the SEC, the investment adviser employed a compliance officer who performed virtually no compliance-related functions during a two-year period. In addition, the SEC alleged that over a three-year period, the investment adviser only enforced written compliance policies and procedures designed primarily to address his predecessor's broker-dealer activities.

Establish valuation policies and procedures: Fund managers should establish valuation policies and procedures that are:

- Described consistently in the fund's documents (such as the offering document, marketing materials, audited financial statements, etc.),
- Implemented in practice, and
- Subject to periodic review and adequate supervision.

Seek independent, third-party verification: Investment managers that have significant illiquid investments in their fund portfolios should also consider:

- Having the fair value of the fund's most significant illiquid holdings be independently verified by a third party on at least an annual basis.
- Establishing "side pockets" to ensure that the economic performance is properly allocated to the participating investors, when appropriate.
- Implementing procedures to ensure that market-based inputs are appropriately factored into the valuation.

    o **Important**: Most of the recent SEC cases concerning valuation involve events that occurred during the financial crisis of 2007-2008. The point here is that even in a period of market dislocation, the inputs based on market data have to be taken into account in valuation.

Make compliance a priority

In light of the SEC's ongoing interest in investment advisers, funds should make compliance a priority by ensuring there is robust supervision of employees and satisfactory internal controls within the firm. Funds should also carry out periodic comprehensive reviews of its operations in order to identify gaps in compliance programs, and make changes as needed in light of new activities or products it offers.

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This article has been published simultaneously by Rothstein Kass.

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[1] Bruce Karpati, "Private Equity Enforcement Concerns." Speech delivered at the Private Equity International Conference, New York, January 23, 2013.

[2] On June 6, 2013, the SEC announced that the Division was renamed the Division of Economic and Risk Analysis to reflect the "breath of its still-expanding responsibilities." SEC Press Release, June 6, 2013: "SEC Renames Division Focusing on Enforcement and Risk Analysis."

[3] Bruce Karpati, "Enforcement Priorities in the Alternative Space." Speech delivered before the Regulatory Compliance Association, New York, December 18, 2012.

[4] By way of comparison, according to our research, in the two years prior to October 2012 the SEC brought just two cases involving valuations.

[5] Luis A. Aguilar, "Doing the Right Thing: Compliance that Works for Investors." Speech delivered at the Regulatory Compliance Association's Regulation, Operations and Compliance (ROC) 2013 symposium, New York, N.Y., April 18, 2013.