SEC Actions - Fund Investment "Mispricing" and "Mismarking"

Overview:

The SEC's Office of Compliance Inspections and Examinations ("OCIE") has named valuation practices as one of its areas of focus in both investment advisor and investment company examinations.

Best practices and procedures that can help meet greater SEC regulation and scrutiny include:

- Adoption of written/documented valuation policies and procedures;
- Establishing an internal pricing committee;
- Maintaining an advisory board or committee;
- Continuous investment monitoring; and
- Appointing an independent third-party valuation provider.

The following cases are examples of compliance failures of accounting principles, in which the Securities and Exchange Commission pursued action against Fund Managers for "mispricing" or "mismarking" securities:

Securities and Exchange Commission Charges Florida Investment Adviser with Fraud (May 2020)[1]

TCA Fund Management Group Corp. ("TCA") and TCA Global Credit Fund GP, Ltd. ("GP" or "Fund", and with TCA, "Defendants"), a Florida based registered investment adviser, was charged by the Securities and Exchange Commission ("SEC") with fraudulently engaging in revenue recognition practices that inflated revenue and the net asset value ("NAV"). TCA was compensated based on the NAV of the funds and GP was compensated on the amount of the funds' profitability.

The SEC's complaint charges that since 2010 and continuing through at least November 2019, TCA fraudulently engaged in revenue recognition practices that inflated revenue and NAV using two methods.

1. Between April 2010 and December 2016, the Fund's lending business would recognize revenue from loan fees when nonbinding term sheets were executed. Recognizing these fees at the execution of the term sheet artificially increased profits and NAV until the revenue was actually earned at the time of the loan closing or removed from the books if the loans never closed.

2. Between the second half of 2016 and November 2019, TCA would recognize investment banking fees as revenue at the time investment banking services agreements were signed even though (a) these companies lacked the financial wherewithal to pay the fees unless the Fund was able to successfully secure financing, which rarely occurred, and (b) the Fund had provided few if any services to the companies at the time of the agreement.

1 https://www.sec.gov/litigation/litreleases/2020/lr24815.htm

Per the SEC’s complaint, these practices caused GP to report to investors that they were profitable every month, with an ever-increasing NAV. In truth, the practices led to overstated NAV by as much as $29 million from the loan fees and $130 million of investment banking fees. For 2018 the Fund’s auditor issued a qualified opinion including $61.6 million in investment banking income (47% of total) and $384 million in assets (89% of total). Many of the Fund’s loans are now in default, including 46% currently in litigation and as of January 2020, the Fund is winding up affairs.

The SEC’s complaint charged the defendants with violations of Section 17(a)(1), (2) and (3) of the Securities Act, violation of Section 10(b) and Rule 10b-5(a), 10b-5(b) and 10b-5(c) of the Exchange Act, violation of Section 206(1), (2), (4) and Rule 206(4)-7 and 8(a) of the Advisers Act, and violation of Section 207 of the Advisers Act.

Securities and Exchange Commission vs. SBB Research Group, LLC, Samuel B. Barnett and Matthew Lawrence Aven (September 2019)

SBB Research Group, a Chicago-area hedge fund adviser, and two (2) of its executives were recently charged with a multi-year deception that inflated its managed funds’ values.[2]

Samuel Barnett, CEO, and Matt Aven, Chief Operating and Compliance Officer, were named in the charges filed by the SEC stating that the executives mislead potential investors. Instead of using fair value, required by GAAP and as promised by the fund managers, when recording investments, an internal valuation model was used that artificially inflated the value of structured notes. Consequently, SBB misstated the funds’ historical performance and overcharged investors approximately $1.4 million in fees.

Once the SEC became aware of the valuation issues, the defendants took measures to conceal the fraud from investors and auditors. The SEC noted that SBB hired a 3rd-party valuation firm in 2016 which resulted in a material mark-down of its investments. The fund underhandedly credited investors for the overcharged fees but did not disclose the underlying problem.

The SEC’s complaint charged the defendants with violations of Sections 206(1), (2) and (4) and 207 of the Investment Advisers Act of 1940 (“Advisers Act”) and Rules 206(1), (2), and (4)-8 thereunder; Defendants also violated sections from the Securities and Exchange Act of 1934 (“Exchange Act”) and the Securities Act of 1933 (“Security Act”). The investigation was conducted by the Complex Financial Instruments Unit and the Chicago Regional Office with assistance from the San Francisco Regional Office. Final judgement is still pending.

Securities and Exchange Commission vs. Stefan Lumiere (March 2018)
Securities and Exchange Commission vs. Christopher Plaford (July 2019)

Fund managers Christopher Plaford and Stefan Lumiere were charged by the SEC for falsely inflating the value of securities held by Visum Asset Management.[3] The two managers used sham broker quotes to mismark approximately 28 securities per month. The funds reported both artificially inflated returns and monthly net asset values, which generated inflated management and performance fees.

2 https://www.sec.gov/litigation/complaints/2019/comp24680.pdf
3 https://www.sec.gov/litigation/litreleases/2019/lr24548.htm

Plaford was charged, pled guilty, and was sentenced to serve time along with three years' supervised release. He was also sentenced to $7,311 in fines and criminal forfeiture of $6,611. Final judgement on July 15, 2019 barred him from the securities industry and enjoined him from violating the antifraud provisions of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 204A, 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder.

Luminere also pled guilty and was sentenced to eighteen months imprisonment with three years' supervised released. He was ordered to pay a $1 million fine. Final judgement for Lumiere barred him from the securities industry and enjoined him from violating Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and Sections 206(1), 206(2), and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder.[4]

Securities and Exchange Commission vs. Paul Alar, and West Mountain, LLC. (July 2019)[5]

Paul Alar and his investment adviser firm, West Mountain, LLC, were charged by the SEC for fraudulently overvaluing assets in two funds they managed. In late 2016, West Mountain and Alar began directing two funds to invest in subsidiaries of two (2) privately-held companies. At the time of the investments, both companies had limited operations with minimal revenues and employees, but Alar and West Mountain recorded a collective unrealized gain of $18.6 million, relating to such investments, resulting in approximately $900,000 in additional management fees.

The SEC alleged that in valuing the unrealized gains, West Mountain and Alar falsely represented to investors that independent valuations by a third-party supported their valuations, while knowing that the third-party stated it "should not be regarded as an independent valuation" as such valuations relied on overly optimistic assumptions provided by the two companies. The investment adviser's auditors also advised that the valuation methodology used to calculate the unrealized gains was inappropriate and unreasonable. Further in 2017, West Mountain and Alar misrepresented that one of the companies was actively negotiating an agreement that would create significant gains for investors. According to a complaint filed by the SEC, the active negotiations never existed.

The SEC's complaint charged the defendants with violating the antifraud provisions Sections 206(1), (2) and (4) of the Investment Advisers Act of 1940 and Rule 206(4)-8 thereunder. The SEC is seeking monetary relief and permanent injunctions.[6] Final judgement is still pending.

In Re Swapnil Rege (July 2019)

Former portfolio manager and trader, Swapnil Rege, was charged by the SEC for mispricing private fund investments from June 2016 to April 2017 while he was employed by a fund adviser in Darien, Connecticut. By mispricing investments, he was able to artificially inflate fund profits and overstate the fund's net asset value. As a result, excessive management fees were charged to the Fund, of which $600,000 was paid in excess compensation to Rege.

In September of 2015, Rege suggested that the fund adviser stop using counterparty quotes and begin using a model to determine the fair value pricing for interest rate swaps and swaptions in the fund. The model he

4 https://www.sec.gov/litigation/litreleases/2018/lr24061.htm
5 https://www.sec.gov/litigation/complaints/2019/comp24539.pdf
6 https://www.sec.gov/litigation/litreleases/2019/lr24539.htm

proposed had various inputs that were alterable by the fund. Although the Fund Adviser instructed Rege and other portfolio mangers to use the model's default inputs and settings, Rege changed the default discount curve settings in the pricing model when valuing certain swaps and swaption positions. Rege used inconsistent discount curves for short and long positions resulting in artificial gains for the Fund.

Rege's conduct caused the Fund Adviser to violate Section 206(1) and Section 206(2) of the Advisers Act. Rege was fired in April 2017 after the Fund Adviser's realization that Rege was unable to support the valuation methodology. The Fund Adviser, shortly thereafter, withdrew its registration with the SEC as an investment adviser.

The SEC is proposing to have Rege barred from the securities industry, 3 years' supervised release, and pay disgorgement of $600,000, $49,170.84 in interest, and a $100,000 fine. Final judgement is still pending.[7]

In Re Deer Park Road Management Company, LP, and Scott E. Burg (June 2019)[8]

The SEC filed a complaint against Deer Park Road Management Company, L.P., a private fund manager in the mortgage-backed securities industry, due to failing to adopt Section 206(4) of the Advisers Act and Rule 206(4)-7 relating to valuing fund assets from October 2012 through December 2015. Deer Park's policies were unable to sufficiently address the risk that its traders were undervaluing securities. In addition, they failed to guard against its traders providing inaccurate information to a pricing vendor and using those prices it got back to value bonds. Deer Park failed to implement its existing valuation policy and undervalued client assets by failing to maximize relevant

7 https://www.sec.gov/litigation/admin/2019/ia-5303.pdf
8 https://www.sec.gov/litigation/admin/2019/ia-5245.pdf