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

Overview:

The SEC's Division of Examinations ("DOE"), formerly known as the Office of Compliance Inspections and Examinations ("OCIE"), has continued to increase focus on valuation practices for investment advisor and investment company examinations.

As discussed in recent Risk Alerts posted by DOE, 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:

SEC Charges Infinity Q Founder with Orchestrating Massive Valuation Fraud (February 2022)[1]

On February 17, 2022, the Securities and Exchange Commission charged James Velissaris, former Chief Investment Officer and founder of Infinity Q Capital Management, with overvaluing assets by more than $1 billion while pocketing tens of millions of dollars in fees.[2]

The SEC's complaint alleges that from at least 2017 through February 2021, Velissaris engaged in a fraudulent scheme to overvalue assets held by the Infinity Q Diversified Alpha mutual fund and the Infinity Q Volatility Alpha private fund. Velissaris executed the overvaluation scheme by altering inputs and manipulating the code of a third-party pricing service used to value the funds' assets. The allegations also state that through his fraudulent conduct, Velissaris collected more than $26 million in profit distributions due to such overvaluation.

In an attempt to cover up his scheme, Velissaris deceived the staff by creating backdated minutes of valuation meetings that never occurred and altering documents that described Infinity Q's valuation policies. Forged term sheets

1 https://www.sec.gov/news/press-release/2022-29
2 https://www.sec.gov/rules/ic/2021/ic-34198.pdf

were also sent to the auditor of the mutual fund and the private fund.

During a time of volatile markets in the wake of the COVID-19 pandemic, by masking actual performance, Velissaris sought to thwart redemptions by investors who likely would have requested a return of their money had they known the funds' actual performance. At times, the funds' actual values were half of what investors were told.

In February 2021, Velissaris was removed from his role with Infinity Q after the SEC confronted the firm with information suggesting that Velissaris had been adjusting the third-party pricing model. Several days later, at Infinity Q's request and to protect shareholders, the Commission issued an order (Investment Company Act Rel. No. 34198 (Feb. 22, 2021)) to suspend redemptions of the mutual fund.

The SEC's complaint, filed in the U.S. District Court for the Southern District of New York, charges Velissaris with violating antifraud and other provisions of the federal securities laws. The complaint seeks permanent injunctive relief, return of allegedly ill-gotten gains, civil penalties and to bar Velissaris from serving as a public company officer and director.

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.[3]

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.

3 https://www.sec.gov/litigation/complaints/2019/comp24680.pdf

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.[4] 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.

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.[5]

Securities and Exchange Commission vs. Paul Alar, and West Mountain, LLC. (July 2019)[6]

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

4 https://www.sec.gov/litigation/litreleases/2019/lr24548.htm
5 https://www.sec.gov/litigation/litreleases/2018/lr24061.htm
6 https://www.sec.gov/litigation/complaints/2019/comp24539.pdf

injunctions.[7] 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 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.[8]

In Re Deer Park Road Management Company, LP, and Scott E. Burg (June 2019)[9]

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 observable inputs, such as trade prices.

Scott Burg, CIO of Deer Park, was also named in the complaint due to his involvement with overseeing the valuation

7 https://www.sec.gov/litigation/litreleases/2019/lr24539.htm
8 https://www.sec.gov/litigation/admin/2019/ia-5303.pdf
9 https://www.sec.gov/litigation/admin/2019/ia-5245.pdf

of certain assets in the flagship fund and approving valuations that the traders flagged as "undervalued" with notations to "mark up gradually." An unqualified committee comprised of the principal's relatives and others also oversaw the valuations.

Deer Park did not admit or deny the allegations but consented to a censure. They agreed to cease and desist from committing or causing any current and future violations of a provision of the Investment Advisors Act requiring reasonably designed policies and procedures. The fund manager was ordered to pay a $5 million penalty to settle charges and Berg was ordered to pay a $250,000 penalty.

How Houlihan Capital Can Help

Houlihan Capital can review a fund's valuation policies and provide clients with independent valuations of geographically diverse assets ranging from single investments to multi-class portfolios. The firm has a history of working closely with regulators, auditors, third-party administrators, investors, and some of the world's largest private investment funds.

For more information, please contact:

Marlee Gutierrez
Sales & Marketing Manager
312.450.8649
mgutierrez@houlihancapital.com