SEC Fines Fund Manager $5 Million Over Undervaluation of Assets

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A recent action where the SEC focused on the presumably conservative *undervaluation* of assets suggests that it is more than willing to use valuation as a hook to deter “smoothing” of returns. As we previously noted, while the SEC consistently announces that valuation is a “key area of focus,” it is uncommon for regulators to second guess valuation determinations in the absence of other potential violations. However, failure to adhere to stated valuation policies/procedures is one situation that may lead to heightened regulatory exposure and disputes.

Earlier this month, the SEC announced a settled action against Deer Park Road Management Company, LP, a hedge fund that focuses on distressed securities (in particular, pre-2008 residential mortgage-backed securities). The SEC’s order focused on two technical violations:

1. Failing to adopt and implement reasonably designed compliance policies and procedures relating to valuation of fund assets; and
2. Failing to implement its existing valuation policies.

First, the SEC argued that Deer Park’s valuation policies and procedures weren’t reasonably designed because they lacked procedures detailing how to use the market inputs available to Deer Park that were relevant to RMBS assets held by its flagship fund. Consequently, the SEC concluded that these procedures did not promote consistency or mitigate the potential conflict of interest from traders valuing the securities that they managed. Second, the SEC alleged that Deer Park didn’t implement the policies and procedures that required Deer Park’s traders to “maximize observable inputs such as trade information.” The SEC’s order indicates that some of the RMBS assets at issue were presumably Level 2 assets under GAAP and Accounting Standards Codification 820 (“ASC 820”), requiring the use of observable inputs. However, the SEC alleged that accessible trade information was repeatedly ignored in favor of more discretionary approaches that allowed traders to systematically undervalue the fund’s assets. Consequently, traders were able to mark up assets gradually instead of marking them to observable market inputs.

However, in this particular valuation case, the undercurrents and factual backdrop are far more interesting than the technical violations cited by the SEC. Consider the following factors:

- Traders were *conservative* in valuing assets;
- The fund was generating *lower fees* on AUM than it would have been if the traders valued the assets as the SEC required; and
- There was *no disgorgement*, perhaps suggesting that there was no quantifiable harm to investors (which could have hypothetically occurred if investors bought in or redeemed at artificially low prices).

Despite these mitigating factors and the manager's subsequent remedial efforts, the SEC imposed a $5,000,000 penalty.

A closer read of the order reveals that the SEC's real focus may not have been valuation, *per* se, but to discourage artificially smooth performance reporting. The SEC characterized Deer Park as "one of the most consistent performing hedge funds in the country," and focused on the fact that from 2009 through 2014 the fund's returns were over 20% each year, and that it hadn't had a down month for 80 consecutive months prior to October 2015. The SEC also noted that Deer Park had managed to grow the fund's AUM from several hundred million dollars to more than $1.5 billion during the period in question.

In addition, the SEC noted that Deer Park's stated strategy focused on buying deeply discounted, high-yielding RMBS for its flagship fund. Although the practice of slowly marking up RMBS assets would presumably lead to lower AUM, it would also show higher yields on those assets during earlier periods.

All in all, the SEC appears to be making good on its promise to keep valuation as a key area of focus, and appears more than willing to examine in detail the valuation process and procedures hard-to-value assets as well as fund managers' corresponding disclosures to investors.

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