

## SEC Sanctions Hedge Fund Advisory Firm For Improper Valuations of Illiquid Securities

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Returning to an enforcement priority repeatedly articulated over the years, the **SEC** recently [imposed sanctions](#) on a registered investment advisory firm and two principals arising out of an alleged scheme to inflate the valuations of illiquid mortgage-backed securities held by private investment funds managed by the adviser. The SEC charged that the overvaluations improperly increased the management and performance fees collected by the adviser.

In ***AlphaBridge Capital Management, LLC***, the Order reflecting the parties' agreement to an aggregate penalty of \$5 million, alleged that the firm systematically overstated the value of securities known as interest-only and inverse interest-only floaters. These unlisted, thinly-traded securities are tranches of collateralized mortgage obligations which receive a coupon payment that fluctuates as interest rates change. In the absence of a robust market, these securities are typically valued based on discounted cash flows. The computation of future cash flows and the resulting valuations are heavily dependent on a projection of the percentage of the underlying mortgages that are expected to be prepaid at any given time.

Since 2001, the funds' investors, administrator and auditor were told that the adviser obtained independent price quotes for these securities from registered representatives of two reputable broker-dealers, and used the average of these quotations for valuation purposes. Throughout the relevant period, these registered representatives provided written price quotes each month to the funds' administrator and its auditor.

The SEC claimed that, over time, the process for obtaining valuations changed and, by 2010, the adviser supplied its own valuations to the registered representatives for them to misrepresent as their own to the funds' administrator and auditor. In 2011 and 2012, the valuations increasingly diverged from other valuation sources and the auditor asked to speak directly to the registered representatives to confirm the basis for their quotations. The adviser arranged for one of the registered representatives to respond to the auditor's inquiries and, purportedly scripted the representative's false responses to further mislead the auditor and the funds' investors.

Based on these allegations, the SEC charged the advisory firm, and its chief compliance officer with

willfully violating the antifraud and other provisions of the Investment Advisers Act of 1940. Both the firm's chief executive officer and CCO were also charged with willfully aiding and abetting AlphaBridge's violations. In addition to the \$5 million penalty, AlphaBridge and its CEO were censured, the CCO was barred from working in the securities industry for at least three years, and AlphaBridge agreed to wind down the funds. In a separate Order, the SEC charged one of the registered representatives with willfully aiding and abetting the adviser's violations. In order to settle the aiding and abetting charges, the registered representative agreed to a one year bar from working in the securities industry and a \$15,000 penalty.

Investment advisers should be reminded that, as an examination and enforcement priority, regulators will continue to seek confirmation that the valuation procedures described to investors are actually followed. While the facts of *AlphaBridge* appear extreme, all advisers should nevertheless take care to ensure their current documentation accurately reflects current practice.

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