JACKO LAW GROUP, PC

Legal Risk Management Tip
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CONTINUED FOCUS ON VALUATION REMAINS AN SEC PRIORITY

Introduction

Valuation, and the methodology used to value client holdings and assess fees, continues to be an SEC priority for 2014.[1] In valuing client holdings, most advisers will use "market values" for which market quotations are readily available. Should such market quotations be unavailable, "fair value" generally is used, which is valuation as determined in good faith by the manager. While this may appear to be a simple concept, the valuation process has many subjective elements and can be complex.

In assessing fees, most investment advisers calculate their fees based either on the value of their assets under management or on increases in performance valuation over a particular time period as outlined in client and investor disclosure documents. As such, properly valuing client assets has, and continues to be, a focus of the Securities and Exchange Commission ("SEC") due to the incentive advisers have in overstating the value of these assets.

This month's Legal Risk Management Tip will discuss general approaches to valuation and provide guidance on what managers should consider in developing valuation policies and procedures, particularly in light of recent enforcement actions.

Approaching Valuation

As mentioned above, there are two general approaches to valuation – market valuation, for securities in which market quotations are readily available, and fair valuation, whereby the securities are assigned a "fair value" as determined in good faith by the adviser and/or the fund board of directors, as applicable.[2,3] It is the latter of these prongs that receives the most scrutiny by the SEC, and requires the greatest amount of diligence by advisers.

"Fair Value" of a security is defined as the price the security holder might reasonably expect to receive upon the current sale of such security.[4] Establishing such fair value requires a determination of the amount that an arm's-length buyer, under the circumstances, would pay at that time for the security (also referred to as an "exit price" approach). Fair valuation of a security cannot be based on what a buyer might pay at some later time, such as when the market ultimately realizes the security's true value as currently perceived by the portfolio manager.[5] The SEC also has made it clear that

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[1] *See* http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf.
[2] *See* https://www.sec.gov/about/laws/ica40.pdf.
[3] ASC 820 defines three valuation approaches for fair value measurement including "Market Approach," "Income Approach" and "Cost Approach." One or multiple valuation techniques may be required depending on the circumstances. The full text of ASC 820 can be found in the FASB Accounting Standards Codification (link to the FASB's Web site; registration required).
[4] Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 820, *Fair Value Measurement* ("ASC 820").
[5] *Id.*

investment advisers cannot fair value a security held by its client(s) at a price that is not reasonably achievable on a current basis. For example, a bond should not be valued at par simply because the portfolio manager currently expects to hold the bond in a client's account until maturity.

Advisers who are required to value illiquid or complex securities for which no or little market data is readily available do so pursuant to customized policies and procedures as set forth in accordance with the Investment Company Act of 1940 and/or Investment Advisers Act of 1940, as amended. Generally, such policies and procedures should include: the types of investments in which the adviser and/or fund will invest; when fair valuation calculations are made; the party(-ies) responsible for valuation;[6] and the different factors that may be considered when determining fair value.[7] As the SEC has stated, "no single standard for determining 'fair value in good faith' may be laid down since fair value depends upon the circumstances of each particular case."[8] Thus, it is the adviser's responsibility to ensure that it has implemented effective protocols which are followed during the valuation process.

<u>Valuation Enforcement Actions – Lessons Learned</u>

During the past few years there have been a number of SEC enforcement actions brought against advisers, funds and fund Board of Directors relating to improper valuation. Notably, from October 2012 to June 2013, the SEC filed five (5) cases in which it alleged false or fraudulent fund valuations, compared to just two (2) cases filed during the previous three years.[9] In addition, the SEC has brought actions against advisers for violating their own existing valuation policies by failing to document valuation decisions, failing to hold valuation meetings as frequently as required by the adviser's policies and procedures and failing to follow price override and resolution of price challenges procedures.[10]

Two of these recent enforcement actions include:

- *SEC v. Yorkville Advisors, LLC, Mark Angelo and Edward Schinik*, Civil Action No. 12-CV-7728 (S.D.N.Y.) (GBD) (filed October 17, 2012). The SEC alleges that a hedge fund advisory firm and two of its executives deliberately overvalued the amount of assets under management to hide losses and to increase fees. Yorkville Advisors, LLC ("Yorkville") is an investment adviser that typically invests in start-ups or distressed public companies in return for a promissory note or bond. According to the SEC, this approach became much less lucrative as market conditions changed in 2008, and Yorkville began to inflate the company's net worth in order to increase its management fees. The SEC alleged that Yorkville and the two executives failed to adhere to Yorkville's stated valuation policies, ignored negative information about certain investments in the fund, withheld adverse information from the fund's auditor, and misled investors about: the liquidity of the funds, the collateral underlying the investments, and

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[6] Typically this responsibility is borne by an Investment Management Committee, which is typically comprised of compliance, operations, portfolio management and trading personnel.

[7] Such factors may include: the type of security, the size of the holding, the initial cost of the security, values from other relevant financial instruments, price quotes from dealers and/or pricing services, recent news about the security or issuer, etc. For more factors that may be considered when valuing securities, *see* Accounting Series Release No. 118, "Accounting for Investment Securities by Registered Investment Companies," Investment Company Act Rel. No. 6295 (Dec. 23, 1970).

[8] *See* http://www.ici.org/pdf/pub_11_valuation_volume1.pdf.

[9] *See* http://www.dlapiper.com/en/us/insights/publications/2013/06/sec-continues-to-focus-on-fair-value-practices-o__/.

[10] *Id.*

Yorkville's use of a third-party valuation firm (when in fact a valuation firm had not been used in several years).

- *In the Matter of Directors of Morgan Keegan*, IA Rel. No. 30557 (Jun. 13, 2013). This proceeding involved five mutual funds that were heavily invested in complex structured product securities and below-investment-grade debt. The SEC accused eight former directors (the "Directors") of Morgan Keegan of failing to police the portfolio managers that oversaw these funds and thereby allowed toxic mortgage assets to be overvalued prior to the financial crisis. More specifically, the SEC alleged that the Directors delegated their asset-pricing responsibilities to the Adviser's valuation committee without asking meaningful questions, nor requiring specification of a fair valuation methodology or continuously reviewing the appropriateness of that methodology. The SEC further claimed that as a result of the Directors' failures, one of the funds fraudulently overstated its net asset value. The matter was settled, without the Directors admitting or denying any of the findings, whereby the Directors were ordered to cease and desist from committing or causing any future violations, but were not formally censured and were not required to pay any monetary penalty.[11] The settled order also found that the directors caused the funds' violations of Rule 38a-1 under the Investment Company Act, which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws.

Conclusion

Reviewing and testing the effectiveness in protocols for valuing client holdings and assessing fees should continue to be a top priority in your compliance program. Begin by reviewing your valuation policies and procedures to ensure that the methodology for fair valuing illiquid or difficult to value instruments is clear. Review the implementation of this methodology as followed by your Investment Management Committee, operations personnel and portfolio management team. Assess the calculation of management and performance fees to review for accuracy. Check that your valuation policies and procedures address potential conflicts of interest; designate who is responsible for oversight; and use specific methodologies for pricing portfolio securities. As applicable, include a summary of these policies in client disclosure documents, such as offering documents, marketing materials, etc., all of which should be subject to periodic review and supervision. Seek an independent, third-party verification of your valuation calculations on a periodic basis, particularly for those advisers who have a significant amount of illiquid or complex securities.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

Author: Robert Boeche, Attorney; Editor: Michelle L. Jacko, Managing Partner, JLG. JLG works extensively with investment advisers, broker-dealers, investment companies, hedge funds, banks and corporate clients on securities and corporate counsel matters.

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[11] It should be noted that related parties to this matter paid substantial fines and penalties in connection with a 2011 settlement that included $100 million in disgorgement by the fund's investment adviser, a $250,000 fine for the fund's portfolio manager, and a $50,000 fine for the head of fund's accounting group.