

# Valuation Issues, SEC Examinations & Enforcement Actions

June 19, 2013





# Speakers



**James E. Anderson**  
Partner  
WilmerHale



**Drew G. L. Chapman**  
Partner  
WilmerHale



**Lori A. Martin**  
Partner  
WilmerHale



**Frank Fumai**  
Partner  
Deloitte & Touche LLP



**John Marshall**  
Valuation Director  
Deloitte Financial Advisory Services LLP



# SEC Enforcement Environment

## Fiscal Year 2012

- 734 enforcement actions (one less than 2011)
- More than \$3 billion in penalties and disgorgement (an 11 percent increase over 2011)
- 147 investment adviser-related cases accounting for 20% of all enforcement cases, and accounted for the largest category of enforcement cases during that fiscal year

## Actions Addressing Misconduct Stemming from Financial Crisis as of May 1, 2013

- 157 entities and individuals have been charged
- \$1.52 billion in penalties have been ordered or agreed to



# SEC Examinations

- Speech by then Director of OCIE (October 2012)
  - Conflicts of interest and risk governance
  - Side-by-side accounts
  - Affiliation by advisers with broker-dealers
  - Taking undisclosed risks
  - Valuation



## Enforcement Remarks

- Focused on complex illiquid or opaque instruments
- Disproportionate amount of fraud occurring at smaller hedge fund advisers
- Specific concerns include lax valuation, use of side pockets to hide losing positions, not following valuation procedures



## Valuation Cases

- SEC has brought at least seven cases in last two years involving valuation by private fund managers
- Most involve simple fraud as to the value of assets
- Most involve small advisers



## Morgan Keegan Case

- 2010 case against mutual fund adviser
- Involved incorrect valuations of mortgage-backed securities in 2007
- Settled in 2011, finding fraud under Advisers Act Section 206
- Also found violations of compliance program rule (Rule 38a-1 under Investment Company Act)



## Morgan Keegan Directors

- On June 13, 2013, the SEC issued an order making findings and imposing a cease and desist order against the Morgan Keegan independent directors
- The order includes a violation under Rule 38a-1 of the Investment Company Act, which requires investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the fund, including oversight of compliance by the fund's adviser





## Morgan Keegan Directors

- Resolution likely to be major precedent
- Implications for others in asset management, including private fund advisers, especially with respect to reliance on experts



# Valuation

- Exam staff will review the adviser's valuation policies and procedures regarding:
  - The valuation of client holdings, including the methodology for fair valuing illiquid or difficult to value instruments
  - The calculation of management and performance fees, and allocation of expenses to private funds



## Valuation – Lessons Learned

- The portfolio manager’s role in the valuation process needs to be defined, monitored, and subject to appropriate controls
- Valuation policies and procedures should
  - address potential conflicts of interest;
  - designate who is responsible for oversight; and
  - use specific methodologies for pricing portfolio securities (listing factors from ASR 118 is insufficient).
- Get real bids or quotes rather than “accomodation quotes” when possible
- Hot button issue for OCIE and Enforcement



## Fee and Expense Allocation

- “As a fiduciary, it is important that hedge fund advisers allocate their fees and expenses fairly.”  
- *Norm Champ, Director, SEC Division of Investment Management, May 11, 2012*
- OCIE has particular focus on fee and expense allocation
  - Appropriateness of the manager charging an expense as opposed to paying for it out of management fees; and
  - Allocation of expenses among various client funds and accounts.



## Fee and Expense Allocation

- Conflicts arising from managing different clients, investors and products under the same umbrella
  - Broken deal expenses rolled into future transactions that may be ultimately paid by other clients; Certain preferred clients incur no broken deal expenses at all, which are all absorbed by a core co-mingled fund
  - Improper shifting of organizational expenses where certain co-mingled vehicles foot the bill for preferred clients
  - Complementary products supporting each other, such as a primary vehicle making fund commitments to create deal flow for a more profitable co-investment vehicle



# Regulatory Scrutiny

## SEC Enforcement Actions

- Valuation policies and procedures not in place
- Sufficient policies and procedures in place, but not being used in practice
- Issues with actual valuations performed

## Public Company Accounting Oversight Board ("PCAOB") Focus



## Common Themes

### General

- Other investors had valued it at this so we did as well
- It would take too much time/effort

### Income Approach

- Projections aren't available
- Projections aren't reliable

### Market Approach

- There aren't any directly comparable companies
- Multiple adjustments are too subjective so we selected the median/average
- We just marked it to the last round from 3 years ago



## Recurring Issues: In General...

### General

- “Market participant” perspective not considered
- Marketability/control
  - Failure to consider appropriate adjustments
  - Lack of support for discounts/premia
- Price movements not made soon enough
- Macro vs. micro
  - Good monitoring of company/investment
  - Industry/market movements not taken into account
- How good of a measure is par?
- Lack of consistency across organization
- Failure to reconcile approaches





# Recurring Issues: Income Approach

## Income Approach

- Discount Rate
  - Not supported
  - Not tailored to business or projections
- Projections
  - Minimal insight/understanding of projections
- Terminal growth rate/exit multiple
  - Not supported
  - Not appropriate
    - Enormous growth
    - No growth



# Recurring Issues: Market Approach

## Market Approach: Public Companies

- Comparable companies
  - Not related
  - Too big
- Multiple Selection
  - Not adequately supported
  - Adjustments, or lack thereof
  - Comparative analysis
  - Use of the data
  - Picking mean/median without “thought”

## Recurring Issues: Market Approach (cont.)

### Market Approach: M&A Transactions

- Transaction price is not representative (synergies/distress)
- Transaction data is stale

### Market Approach: Financing Rounds (and Sharespost etc.)

- Date of transaction
- Rights of recent share class
- Dynamics of the transaction
- All insiders
- Down rounds
- Size of trades/who's trading
- Monitoring/movement when an IPO is imminent



# OCIE Exam Program

## National Exam Program

- OCIE's mission is to protect investors, ensure market integrity and support responsible capital formation through risk-focused strategies that: (1) improve compliance; (2) prevent fraud; (3) monitor risk; and (4) inform policy.
- The National Exam Program plays a critical role in fulfilling OCIE's mission

## Types of Exams:

- Routine Exams
- For Cause Exams
- Sweep Exams
- Presence Exams



# OCIE Exam Program - Presence Exams

- More than 1,500 private fund managers registered as investment advisers in 2012
- New 2 year initiative – Presence Exams of Private Funds
  - 3 Primary Phases:
    - Engagement: Outreach to new advisers--staff letters, risk alerts, special studies, speeches, Compliance Outreach Program/seminars for CCOs
    - Examination: Exam staff focus on one or more of the following high-risk areas--Marketing, Portfolio Management, Conflicts of Interest, Safety of Client Assets, or Valuation
    - Reporting: Report observations to the Commission and the public
- Benefits: Brevity and gain experience of an exam



# OCIE Exam Program

## Examination Priorities for 2013 for IA-IC Exam Program

- Safety and Valuation of Assets
- Conflicts of Interest Related to Allocation of Investment Opportunities and Fees and Expenses
- Conflicts of Interest Related to Compensation Arrangements
- Marketing/Performance
- Fund Governance
- New Registrants (private fund advisers)
- Dually Registered Investment Advisers/Broker-Dealers
- “Alternative” Investment Companies
- Payments for Distribution in Guise
- Money Market Funds
- Compliance with Exemptive Orders
- Compliance with Pay to Play Rule



## Fee and Expense Allocation Tips

- Clear Disclosure – Fee and expense disclosure should state clearly the amount an adviser is earning in connection with managing investments as well as expense allocations between a firm and its clients
- Responsible Reporting - Advisers should ensure the timeliness, accuracy and completeness of financial reporting, including expense allocations
- Adequate Policies and Procedures - Policies and procedures should address the allocation and monitoring of fees and expenses



## Fee and Expense Allocation Tips

- Allocate Fairly – Advisers have a fiduciary obligation to allocate expenses fairly
- Oversee Ledger - OCIE looking line-by-line at the general ledger and reviewing invoices, both as a method of policing adviser activities and to review the appropriateness of expenses passed on to clients. Compliance oversight of expenses and allocation can help mitigate risk





## Calculation of Fees

- OCIE will review conflicts of interests related to compensation arrangements, including the calculation of fees
  - Conflicts of interest may arise when an adviser has the incentive to allocate trades to the hedge fund at the expense of affiliated mutual funds because of the opportunity for the investment adviser to earn greater profits from its management of hedge funds
  - Temptation to overvalue assets to boost compensation has emerged repeatedly in enforcement cases



## Calculation of Fees Tips

- Focus on valuation of assets: SEC bringing cases against private funds for inflating values of certain illiquid assets
- Only get paid for actual services performed: SEC sued investment adviser, alleging that for more than a decade, adviser charged fund for advisory services that adviser did not provide. (*SEC v. AMMB Consultant Sendirian Berhad*, Case No. 1:12-cv-01052 (DDC, filed June 26, 2012))



# An Auditor's View – Current Trends

## Heightened Focus on Investment Valuation

- Regulators
- Accounting Standard Setters

## Additional Documentation

- Internal records
- Financial Statement Transparency

## Red Flags

- Completeness of information
- Valuation Process Governance



## An Auditor's View – Current Trends (cont.)

### Third-Party Valuation Assistance

- Pricing Services
- Private Equity Level 3 Investments

### Significant Investment in Compliance

- Expanded legal departments
- Readiness efforts



# The Future Outlook

## Pursuing New Growth Opportunities

- Expanded Products/Investments

## Continued rulemaking

- Accounting/Auditing/Regulatory Changes

## Focus on Operational Efficiencies

- Back office Outsourcing and Technology Solutions

***Continued Risk and Focus in the Valuation Arena***



## Steps to Reduce Risk of SEC Enforcement Inquiry

- Since CFOs are charged with overseeing the business of the investment manager, they are best positioned to detect and correct conduct that may not comply with the fiduciary duty standard
- Make sure clients' interests are placed ahead of the interests of the adviser and its principals
- Integrate compliance risk into overall risk management process and ensure CFOs and others are able to spot and correct conflicts of interests proactively



## Steps to Reduce Risk of SEC Enforcement Inquiry

- Use knowledge of the operation of the firm's portfolio to ensure valuations are fairly represented and investors are accurately informed of the status of their investment
- If available, use Limited Partnership Advisory Committee to resolve conflicts of interest. This step goes far in demonstrating good faith
- Have the organizational authority to identify and resolve potential issues



## Steps to Reduce Risk of SEC Enforcement Inquiry

- If CFO is member of investment committee, CFO can ensure firm executes transactions at arm's length and follows the firm's stated strategy
- Cooperate with exam staff while an examination takes place and implement necessary corrective steps if staff identifies deficiencies or possible violations





# Questions?

**James E. Anderson**

+1 202 663 6180

James.Anderson@wilmerhale.com

**Drew G. L. Chapman**

+1 212 295 6320

Drew.Chapman@wilmerhale.com

**Lori A. Martin**

+1 212 295 6412

Lori.Martin@wilmerhale.com

**Frank Fumai**

+1 516 918 7873

ffumai@deloitte.com

**John Marshall**

+1 617 437 3359

johnmarshall@deloitte.com