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SEC Announces Two Enforcement Actions Alleging Investment Advisers Inflated Performance

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On May 8th and May 9th, the Securities and Exchange Commission ("SEC") announced two matters reflecting the SEC's continued focus on investment advisors, particularly with respect to valuation issues. In addition to the SEC's scrutiny of the valuation of fixed income securities, these cases reflect the SEC's interest in reviewing valuation policies, practices (including adherence to policies), and disclosures to investors. Both cases also highlight the SEC's willingness to hold supervisors individually responsible when they partake in wrongdoing or fail to take reasonable measures necessary to detect and prevent such violations.

Visium Asset Management

In the first case, the SEC filed an order instituting settled administrative proceedings against hedge fund advisory firm Visium Asset Management, LP ("Visium") for allegedly mismarking securities held in a fund for which Visium acted as an investment adviser. According to the SEC, two Visium portfolio managers used sham broker quotes, received from "friendly" outside brokers, to overvalue securities. The SEC alleged that Visium failed to act when the sham broker quotes were used to falsely inflate returns and overstate fund's reported net asset value ("NAV"), resulting in earn higher performance and management fees. To settle the charges, Visium agreed to pay over $3.1 million in disgorgement *plus* the same amount in a civil penalty.[1]

The fund at issue invested in "over the counter," thinly traded corporate debt instruments. According to disclosures made to investors, Visium's valuation process sought to establish the "fair value" for these securities, calculated by an independent administrator using "established pricing sources including but not limited to Bloomberg and Reuters." Typically, the fund's independent administrator provided Visium with month-end prices from these established pricing sources to value the holdings. Visium's policies indicated that the adviser could override the independent administrator's price only when it viewed the administrator's price as inconsistent with fair value. Even then, Visium could only rely on alternative pricing sources that were reliable, stabile and independent. The valuation procedures specifically permitted reliance on broker marks, but provided that it was "preferential to get at least three dealer marks."

1 As part of the same order, the adviser paid nearly $1.6 million in disgorgement plus the same amount in civil penalty based on allegations that a third portfolio manager traded on insider information.

The SEC's order alleged that, contrary to these disclosures and the adviser's policies and procedures, the portfolio managers overrode the month-end NAV that Visium and the independent administrator should have used on 308 occasions. According to the SEC, when requesting such overrides, the portfolio managers provided alternative pricing based on sham broker quotes procured from "friendly" brokers at one or two of three registered brokerage firms (in only one of the 308 overrides did the portfolio manager provide three broker quotes). Specifically, the SEC alleged that the portfolio managers would ask the friendly broker for a particular price and instruct the broker to send the quote through email or instant message. According to the SEC, this practice, referred to as "U-turn" quotes, made it appear as if the prices were the brokers' own quotes, but did not in fact reflect the price at which the dealer was willing to transact.

Additionally, the SEC alleged that, on at least two occasions, the portfolio managers caused the fund to pay above-market prices on trades executed late in the month to inflate the apparent value of bonds already held by the fund.

According to the SEC's order, the mismarking scheme routinely cause the fund to overstate its month-end NAV by approximately 2.4% to 7.2% from July 2011 to December 2012, as well as its audited year-end NAV by approximately 5.1% to 7.0% for 2011 and 2012, respectively. As a result, certain investors allegedly purchased or sold interests in the fund at an artificially inflated NAV, leading Visium to receive ill-gotten performance fees and management fees for a total of $3,156,409. The SEC further alleged that, moreover, Visium relied on the sham broker quotes to classify and report certain distressed securities as Level 2 assets under the Financial Accounting Standards Board Accounting Standards Codification Topic 820 ("ASC Topic 820")) (*i.e.*, assets that have observable market inputs for valuation purposes) when, in fact, many of the assets should have been classified as Level 3 assets (*i.e.*, assets that lack observable market inputs). According to the SEC, this misclassification may have caused investors to overvalue the amount of liquid assets held by the fund.

Furthermore, the SEC alleged that the mismarking scheme rendered certain statements made to the fund investors and potential investors false and misleading. Specifically, the SEC found that the scheme caused Visium to make misstatements in its 2012 and 2013 annual amendments to its Form ADVs. The SEC also alleged that Visium failed to take adequate steps to ensure proper fair value classifications were used and that its policies and procedures were followed. Accordingly, the SEC charged Visium with willful violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Sections 204A, 206(1), 206(2), 206(4), and 207 of the Advisers Act and Rules 206(4)-7 and 206(4)-8 thereunder.

Individuals involved in the case were also charged. In a separate order issued on the same date, the SEC alleged that Visium's CFO, Steven Ku, failed to reasonably supervise the two portfolio managers by failing to respond appropriately to red flags that should have alerted him to their misconduct. For example, Ku received a report that showed the two portfolio managers used overrides to price, on average, a quarter of the positions held in the fund. Ku received a 12-month bar and agreed to pay $100,000 in civil penalty.[2]

2 Earlier this year, the SEC additionally obtained a final judgement in the Southern District of New York against one of the portfolio managers and permanently barred him from the securities industries. Charges against the other portfolio manager, also proceeding in the Southern District, have been stayed pending a completion of a parallel criminal case.

Premium Point Investments

In a second recent matter, the SEC announced charges against investment adviser Premium Point Investments LP ("Premium Point") for inflating the value of private funds it advised by hundreds of millions of dollars. The same complaint also charged Premium Point's CEO and Chief Investment Officer, a former partner and portfolio manager, and a former trader for the conduct. The SEC's complaint alleged that when the performance of investment funds it advised declined, Premium Point obtained inflated price quotes from a broker in exchange for a promise to send trades to the broker. Premium Point allegedly used these inflated broker quotes and inconsistent valuation methodologies to calculate and report the funds' monthly valuation to investors. As a result, Premium Point overvalued its funds by 14%, on average, each month. The SEC's investigation and litigation are ongoing.

The funds at issue in the complaint invested in a variety of mortgage-backed securities, including subprime, interest-only non-agency, and new-issue prime jumbo mortgage bonds. According to offering documents and other disclosures, Premium Point's valuation process sought to determine the fair value of securities held by its funds by requesting pricing from brokers and pricing vendors. Under the firm's policy, if five or more prices were received, the highest and lowest price would be excluded and the average of the prices would be used. If two to four prices were received, the average of the prices would be used. Premium Point's policy also indicated that unlisted securities would be valued at the mean between the "bid" and the "ask" prices, otherwise known as the "mid" price.

The SEC's complaint alleged that Premium Point arranged with a brokerage firm to obtain sham broker quotes to value securities. At the end of the monthly valuation process each month, Premium Point allegedly determined the prices it needed in order to meet certain performance targets and told the broker the prices it wanted to see for certain bonds. The brokerage firm gave Premium Point the prices it wanted for the bonds, and in return, Premium Point executed trades with the brokerage firm. The SEC complaint points to specific texts sent by a representative of the brokerage firm reflecting the arrangement. For example, one text stated "[The Trader] gonna have to show me/[Brokerage Firm] some more love if he thinks I'm gonna just mark all those bonds where he wants them."

The SEC's complaint also alleged that Premium Point routinely "imputed" mid-point prices of securities, even when mid-point prices could have been easily obtained by a broker. From January 2012 to February 2016, several pricing services provided only bid-side prices for bonds. Rather than obtain broker quotes in order to properly calculate the mid-point of securities in line with the firm's policy, Premium Point took a bid price for a particular security and added half the spread between the bid and ask prices on a broad sector of securities to "impute" a mid-point price for the security. According the SEC, the imputed mid-point practice resulted in inflated values of securities. In some instances, the bid/ask spreads used to impute a mid-point price were almost at the bid prices themselves, resulting in valuations that were sometimes multiples of an accurate mid-point price.

According to the SEC, the scheme ultimately collapsed when the fund was unable to keep up with investor redemptions. In April 2016, Premium Point informed investors that it intended to restate NAVs for late 2015 and other periods. Premium Point eventually revised its valuation figures and

determined that the funds had been overvalued, by an average of 14% monthly. Premium Point failed to obtain an audit or distribute audited financial statements for 2016 and 2016.

The SEC complaint charges Premium Point and each of the individuals with a variety of charges, including violations of Section 10(b) of the Securities Exchange Act of 1934, Rules 10(b)-5(a) and (c) thereunder, and Sections 17(a)(1) and (3) of the Securities Act of 1933. The complaint also charges Premium Point, its CEO/CIO and the partner/portfolio manager with violations of Sections 206(1), (2), and (4) of the Investment Advisers Act of 1940 ("Advisers Act"), and Rule 206(4)-8(a)(2) thereunder. The complaint further charges the CEO/CIO and the partner/portfolio with aiding and abetting violations of Advisers Act Sections 206(1), (2), and (4) and Rule 206(4)-8(a)(2) thereunder. Finally, the complaint charges Premium Point with violations of Advisers Act Section 206(4) and Rule 206(4)-2 thereunder. The SEC's complaint seeks permanent injunctions, return of any ill-gotten gains with interest, and civil penalties.