CONSTELLATION ADVISERS, LLC

REGULATORY NOTICE: 19-08

Valuation Policies and Procedures Are Invaluable: Takeaways from Recent SEC Enforcement Actions

The SEC recently issued Orders in Administrative Proceedings for improper valuation policies, procedures and practices. *See In the Matter of Deer Park Road Management Company, LP and Scott E. Burg*, IA Release No. 5245 (June 4, 2019) (order available here); *In the Matter of Swapnil Rege*, IA Release No. 5303 (July 18, 2019) (order available here). Constellation has summarized points we believe are most relevant to our clients. This summary is not intended to be a thorough or complete analysis of these enforcement actions and is provided only for informational purposes to assist our clients in implementing appropriate processes and procedures related to valuing assets. Constellation does not practice law and this alert does not constitute legal advice.

Regulatory Requirement

Pursuant to Section 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 thereunder, registered investment advisers are required to implement policies and procedures reasonably designed to prevent federal securities law violations stemming from inaccurate valuations. To comply with regulatory requirements, firms must value assets in conformity with Generally Accepted Accounting Principles ("GAAP"), which generally means valuing assets using Accounting Standards Codification 820 ("ASC 820"). Fair value is defined in ASC 820 as: "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." To arrive at this valuation, firms should use methods that "maximize the use of relevant observable inputs and minimize the use of unobservable inputs." Internal models employed by firms to calculate fair value must be structured to include observable market data, including transaction prices. Utilizing models that do not reflect current market condition creates risk.

Deer Park Violations According to the SEC's Order[1]

In Deer Park, the firm relied heavily on valuation models to fair value assets under management. The firm's policies and procedures, however, did not: (1) include a method for calibrating observable market data; (2) mention any valuation techniques or methodologies, (3) have procedures to promote consistency; (4) provide any guidance or training; and (5) reduce the potential conflict of interest created from allowing traders to value securities they manage. Even though Deer Park's policies stated that the firm would prioritize observable inputs (such as relevant market information and transactions) over unobservable inputs (such as assumptions about inputs) to value bonds, the firm disregarded relevant market transactions including transactions in bonds held by the firm.

Instead of following its policies, Deer Park allowed traders who were involved in the valuation process to use cost and future cash flow analysis to value bonds instead of relevant market transactions. Deer Park also engaged third-party valuation firms who used observable market data when marking bond values, but the firm would ignore or revise third-party valuations that negatively impacted bond yields. To make matters worse, no one on Deer Park's valuation committee had prior experience valuing the bonds that Deer Park traded or determining whether the valuations conformed with GAAP.

As a result, the SEC found that Deer Park willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder and ordered, among other things, the firm to pay a civil money penalty in the amount of $5 million and agree to certain undertakings. In addition, Deer Park's Chief Investment Officer was found to have caused the firm's violations and ordered to pay a civil money penalty in the amount of $250,000.

Swapnil Rege Violations According to the SEC's Order[1]

In Rege, the advisory firm used a model to fair value interest rate swaps and swaptions held in the fund's portfolio. To model the prices of interest rate swaps and swaptions, the advisory firm discounted expected future cash flows to arrive at a net present value on the measurement date. The pricing model included a choice of different discount curves, but the firm used the model's default discount curve setting. Although the discount curves used by the firm were appropriate, Rege would alter the discount curves so that the model discount curve was used for short positions, but a different discount curve was used for long positions. The effect of using different discount curves for short and long positions prevented positions that otherwise had identical or substantially similar underlying terms from appearing in the advisory firm's records as offsetting or nearly offsetting, which created an artificial gain that led the advisory firm to record profits that did not actually exist. For example, Rege's use of differing discount curves caused the advisory firm to record an immediate, single-day profit of approximately $7 million when the offsetting positions should have reflected a net market value at or near $0 for those same positions.

As a result, the advisory firm's account statements reflected overstated investor returns, monthly letters to investors contained inaccurate, overstated return information, and the advisory firm overcharged management fees. When questioned, Rege misrepresented to firm management that his valuation methodology was an accepted practice in the industry. Also, Rege engaged in deceptive trades to create market data that would appear to support his valuations.

---

[1] The factual information and violations described herein are based on an Administrative Order entered by the SEC. The SEC indicated that the findings were made pursuant to an offer of settlement.

As a result of his conduct, the SEC found that Rege willfully aided and abetted and caused the advisory firm's violations of Sections 206(1), 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8 thereunder. For these violations, Rege was barred from the industry and ordered to: cease and desist from violating the securities laws, disgorge $600,000, and pay a civil money penalty in the amount of $100,000.

TAKE ACTION!

Takeaways – Clients Should:

- Confirm valuation policies fair value assets using ASC 820.
- Verify that valuation policies use observable inputs when possible.
- Refrain from overriding observable inputs when valuing assets.
- Apply consistent methodology for fair valuing assets.
- Restrict traders or others with a conflict of interest from valuing assets they manage.
- Appoint members to the valuation committee who have experience in valuing the assets under management and experience with GAAP.
- When relying on underlying managers (i.e., fund of funds) for fair values, take steps to verify that the underlying manager's valuation policies, procedures and practices comport with the takeaways identified above.
- Contact Constellation Advisers for further guidance and assistance.

1212 Avenue of the Americas, 6th Floor, New York, NY 10036 • 212.300.6250