Private Equity
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SEC Sanctions Private Fund Manager and Two Principals for Improperly Valuing Assets and Related Violations

By David Wohl and Venera Ziegler

The Securities and Exchange Commission (SEC) recently settled an enforcement action against a private fund manager and two of its principals for violations of the Investment Advisers Act of 1940 (the Advisers Act) related to improper valuations of fund assets and custody rule violations arising out of such actions.[1]

The SEC alleged that for several years, the manager and the two principals materially overstated the value of an investment held by two funds. The investment, a renewable energy project under development in Mexico (the Project), comprised between 51% and 88% of one fund's total assets during the relevant period (Fund A) and between 11% and 17% of the other fund's total assets (Fund B). Notwithstanding the fact that the Project never started construction, obtained financing or potential customers, the manager and principals represented to fund investors in financial statements for the years ending December 31, 2011 through December 31, 2013 that the Project was worth between $10.8 and $12.7 million. As of December 31, 2014, the Project was written down to zero.

In addition, Fund B issued a line of credit (the Loan) to Fund A representing a significant portion of each fund's assets, which Loan was secured by Fund A's assets (consisting primarily of its interest in the Project). The Loan was issued in September 2008 for $1.5 million with a maturity date of December 31, 2010. The maximum Loan amount was increased three times and the maturity date was extended four times. Fund A never made, and did not have liquid assets to make, any payments on the Loan. Despite Fund A's inability to make payments, the manager and principals never wrote down the Loan's value until 2015, when the entire amount was written off as uncollectible in connection with the preparation of the funds' 2014 financial statements.

[1] The settlement order can be found at https://www.sec.gov/litigation/admin/2017/34-81173.pdf.

The SEC alleged that in contravention of relevant accounting pronouncements, the manager and principals used unreasonable assumptions of future cash flows and did not reflect then-current sales or exit prices in connection with their periodic valuations of the Project[2] and did not use proper methods in valuing the Loan, leading to overstated values for the assets. These valuations were included in the funds' audited financial statements that were sent to fund investors. As a result of this conduct, the manager and principals violated the anti-fraud provisions contained in Section 206 of the Advisers Act and Rule 206(4)-8 thereunder.

In addition, because the valuation methodologies were not consistent with applicable accounting standards, the funds' financial statements were not prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). Since the manager relied on the so-called "audit exception" of the Advisers Act custody rule (which requires fund financial statements to be prepared in accordance with GAAP), the failure to comply with GAAP resulted in a violation of the custody rule.[3]

In connection with the settlement, in addition to agreeing to cease and desist from further violations, the principals were barred from the securities industry (with the right to apply for reentry in two years) and each of the manager and principals was fined $50,000.

This settlement is noteworthy for several reasons. First, while in previous public pronouncements members of the SEC staff have said that they generally will focus on a manager's adherence to its disclosed valuation procedures and not second-guess valuation decisions, clearly those decisions must be reasonable, and the SEC's examination staff will be checking for such reasonableness. Second, according to the settlement order, during the relevant period the manager accrued but did not collect any investment advisory fees from the funds, and subsequently wrote off all related accrued fees. Therefore, managers should be aware that the SEC may bring an enforcement action based on improper valuations even if such valuations do not directly result in inflated fees to clients. In light of this settlement, private fund managers should review their valuation policies and procedures to seek to insure that valuation decisions are reasonable and consistent with relevant accounting pronouncements and GAAP.

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[2] Importantly, in an earlier SEC examination, the manager was notified that the SEC had concerns regarding revenue assumptions underlying the valuations of two energy plants that preceded the Project.

[3] The SEC also alleged that the manager and principals (i) made several misrepresentations regarding the Project's progress in the management discussion and analyses sent to fund investors, (ii) falsely disclaimed having custody of client assets in Form ADV filings and (iii) failed to timely conduct annual reviews of the manager's compliance program in violation of Advisers Act Rule 206(4)-7.

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