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Kirkland AIM

SEC Settles with Private Fund Adviser and Portfolio Manager Over Valuation Policies and Procedures

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On June 4, 2019, the SEC entered into a [consent order](#) (the “Order”) with a private fund adviser and one of its portfolio managers over alleged shortcomings in the adviser’s valuation procedures and the portfolio manager’s role in causing the adviser to assign inaccurate valuations to the fund’s investments. The SEC found that the adviser’s policies and procedures regarding valuation of its assets were not reasonably designed to ensure that its assets were valued at “fair value” in accordance with GAAP.

The Order notes that the adviser’s flagship fund was ranked as one of the “most consistent performing” funds in the country and highlights instances where the adviser’s personnel, including the portfolio manager, repeatedly undervalued securities, only marking them up slowly over time in response to more dramatic increases in pricing from observable inputs. In support of its allegations, the SEC noted numerous internal and external communications where the adviser’s personnel ignored external indications of price increases based on third-party trades and instead assigned their own prices, including:

- a note by the portfolio manager in a valuation spreadsheet that a security was “undervalued” and should be “mark[ed] up gradually” so that the adviser “[could] sell it for profit when needed;” and
- an instance in which the adviser’s external pricing vendor raised the price on a security held by the adviser, and the adviser responded by switching to an alternate valuation methodology because the external vendor’s pricing was felt to be “too aggressive.”

The SEC found that the adviser’s policies and procedures were not reasonably designed to ensure its assets were marked at fair value. Specifically, the Order

highlighted the following practices as deficient:

- the adviser offered insufficient guidance and lacked controls to ensure that prices would maximize observable inputs;
- a substantial portion of the adviser's securities were valued with valuation models, but the adviser did not require the models to be calibrated (as is required by GAAP), and its valuation policies and procedures did not mention any valuation techniques or methodologies;
- the adviser's policies and procedures provided significant discretion as to when to use external prices, including allowing traders the discretion to choose, on a monthly basis, whether to use a third party vendor's price or the adviser's own internal valuations, as well as allowing discretion over selection of specific external pricing sources and decisions to challenge the prices provided by such external sources, without sufficient controls designed to maximize the use of observable inputs; and
- the adviser lacked procedures designed to value securities consistently, as well as to reduce potential conflicts of interest arising from traders' valuations of the securities they managed.

While the specific policy valuation failings highlighted by the SEC are instructive for advisers seeking to improve their own policies and procedures, the Order is especially notable in its focus on properly designed and consistently applied procedures, irrespective of investor harm. Even though the SEC does not allege any harm to investors in the Order, it still found that the adviser's policies and procedures were deficient. The Order comes on the heels of recent SEC suggestions that advisers should be backtesting valuations after sales to determine whether the valuations are reasonable¹ and is a reminder to advisers to stay vigilant in an area that appears to be one of focus for the SEC.

If you have any questions about the matters addressed in this *Kirkland AIM*, please contact the following Kirkland attorneys or your regular Kirkland contact.

Regulatory: Norm Champ, Scott Moehrke, Kevin Bettsteller, Michael Chu, Matthew Cohen, Marian Fowler, Nicholas Hemmingsen, Alpa Patel, Jaime Schechter, Aaron Schlaphoff, Christopher Scully, Robert Sutton, Nathan Schuur, Ryan Swan, Jamie Lynn Walter, Josh Westerholm, Corey Zarse

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1. See, e.g., In re Citigroup Global Markets Inc. and Citigroup Inc. (Aug. 6, 2018),

<https://www.sec.gov/litigation/admin/2018/34-83859.pdf>. In addition, Kirkland attorneys have seen SEC Staff raise questions regarding backtesting of valuations during adviser examinations. ↩

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- [09 May 2019 Kirkland AIM SEC Settles with Private Fund Manager and its Principals Over Alleged Misuse of Fund Assets](#)
- [07 January 2019 Kirkland AIM 2019 Private Fund Manager Compliance Update: U.S. SEC/CFTC Filing Deadlines and SEC Examination Priorities](#)

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