At the beginning of June 2019, the SEC filed an order (Order) instituting proceedings against, and imposing remedial actions on, Deer Park Road Management Company, LP (Deer Park or the Firm), an investment adviser, and Deer Park's chief investment officer (CIO) for violations relating to the Firm's valuation process for certain distressed residential mortgage-backed securities (RMBS). Deer Park is the latest in a line of over a dozen cases relating to the valuation of securities conducted by investment advisers. These cases routinely involve serious sanctions and, in some instances, are accompanied by securities fraud actions brought in parallel by criminal authorities.

At first glance, the SEC's case against Deer Park fits into the mold of a typical valuation case. Indeed, the Deer Park settlement involves a $5-million penalty, charges against an individual and the retention of an independent compliance consultant (ICC). Upon closer inspection, however, the SEC's case does not fit perfectly with precedent – it includes no fraud charges and no suspension or bar from the industry for the CIO. That said, Deer Park is generally instructive in several respects as to the SEC's ongoing push to address valuation-related misconduct.

This article analyzes the Deer Park action, ways it differs from prior SEC valuation cases and lessons that fund managers can learn from it.

For more on Deer Park, see “Recent SEC Action Shows That Even Undervaluing Fund Assets Can Draw Significant Penalties” (Jul. 11, 2019).

SEC Allegations

The crux of the SEC's allegations against Deer Park were summarized in the SEC's press release regarding the case:

An SEC investigation found that [Deer Park], in connection with its flagship STS Partners' fund which has been ranked as one of the most consistent performing hedge funds in the country, failed to have policies and procedures to address the risk that its traders were undervaluing securities and selling for a profit when needed. [Deer Park] also failed to guard against its traders' providing inaccurate information to a pricing vendor and then using the prices it got back to value bonds. CIO Scott Burg oversaw the valuation of certain assets in the flagship fund and approved valuations that the traders flagged as “undervalued” with notations to “mark up gradually.”
Also overseeing valuation was a committee comprised of the principal’s relatives and others without relevant expertise.

Deer Park’s Unique Facts and Considerations

A close review of the Order against Deer Park suggests several reasons why the SEC may have agreed to resolve the case without fraud charges or more serious sanctions for the CIO. The Deer Park case presented unusual circumstances and litigation risks for the Commission because it involved an allegation that Deer Park undervalued its positions. That is, unlike in the typical valuation case, Deer Park was accused of valuing its assets in a way that reduced, as opposed to increased, the Firm’s net asset value (NAV), thereby decreasing the fees paid by investors.

To be sure, there are improper reasons why a hedge fund manager may want to undervalue assets, and the Order suggests that some may be present in this case. For example, if performance is kept down in one period, it makes it easier to show an improvement in performance in the next quarter. In the accounting fraud context, this sort of conduct is referred to as “earnings smoothing.” Consistent therewith, one contemporaneous email quoted in the Order involved a Deer Park trader explaining that, if he had valued the bonds under recent trade prices, he would “mark up gradually every month at least to show we are marking towards fair value.” The SEC also highlighted in the press release and the Order that Deer Park was ranked as “one of the most consistent performing hedge funds in the country.”

Further, the Order quotes emails from the traders in which they recognized that the higher the mark they used, the lower the yield the bond – which was still held in the Firm’s portfolio – would have. For instance, the Order highlights an email from a trader and associate portfolio manager that made it clear he preferred a $32.75 valuation for a position even though it had recently traded for almost $5 more because “it starts to get to below 10% yield” if marked at $33 or above.

Although there can be improper reasons to undervalue a position, the impropriety of undervaluation is perhaps more difficult to convey to a fact finder than that of overvaluation (e.g., it could arguably reflect “conservative” pricing by the investment adviser), which may explain why the SEC agreed to settle without fraud charges.

Additionally, a perhaps more serious flaw in a potential fraud case against Deer Park was the absence of materiality. The Order does not quantify the effect of the undervaluation improprieties and does not allege that those improprieties led to a material misstatement of Deer Park’s NAV. Without materiality, there can be no fraud charges.

Practices and Policies Labeled Problematic by the Order

While the above factors may explain the absence of fraud charges, other factors enumerated in the Order suggest reasons why the SEC nevertheless brought a case and sought significant remedies.
First, the case included conduct by the CIO and had at least some signs that investment professionals were given significant control over the valuation process – control that they used to obtain the desired, but improper, result. While Deer Park’s policies required traders to consult observable inputs from the market when valuing products, the evidence suggested that traders failed to implement that portion of the policies in at least some instances and at times valued positions lower than recent contemporaneous trades. For example, in one valuation spreadsheet, the Deer Park traders included a note that said, “[W]e mark it low. [I]t can trade much higher” and “can sell it for a profit if needed.” In explaining why the CIO was the cause of Deer Park’s valuation failings, the Order notes that the CIO approved valuations even though the explanations included in the contemporaneous documents indicated that, at least in some instances, the traders were not accounting for all market data.

Similarly, the Order emphasizes that Deer Park’s policies gave traders significant discretion over “when to use external prices, selection of prices sources, and when and how to challenge prices” and did not have “adequate controls to address the potential conflict of interest” inherent in the traders having this responsibility. The Order, for example, highlights that, for certain bonds, Deer Park could both consult an external pricing source and value the position internally. Deer Park would then create a “price band” around the external price “plus or minus the lesser of 10% or 4 points.” If the internal price was within this band, Deer Park would use the internal price. If the internal price was not inside the band, Deer Park could then use that portion of the price band closer to its internal mark. As the Order highlights, this practice gave Deer Park the ability to mark the bond 10 percent lower than the external mark.

Second, the Order also homes in on Deer Park’s use of a valuation model that did not take all the steps required by the relevant accounting rules – in particular, Statement of Financial Accounting Standards No. 57 and Accounting Standards Codifications 820. These rules require that, when models are used to set the fair value of a security, they must be calibrated to reflect recent relevant observable data – including transaction prices – to ensure the model reflects the reality of the current market. Despite the fact that Deer Park’s valuation process in practice relied heavily on models, its policies allegedly did not reference the calibration requirement of the rules or provide its traders with any other training on the calibration requirement.

Third, Deer Park’s process for controlling risk did not inspire confidence. Deer Park had a risk management committee, but that committee was composed of friends and family that the SEC alleged did not have sufficient expertise. This included a chief compliance officer who was a brother-in-law of Deer Park’s CEO and an attorney who was another relative of the CEO. Thus, although there is no rule against employing friends and family, the Order is another reminder that the SEC may be more skeptical that those employees are qualified.

For discussion of valuation best practices, see “Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations” (May 11, 2017); “Is the Use of an Independent Valuation Firm Superior to a Manager’s Internal Valuation Process?” (Apr. 23, 2015); and “Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees” (Aug. 16, 2012).
Benefits of the Bargain for Both Sides

In the end, the Deer Park settlement appears to be a compromise where both sides received important benefits from resolving the case. The SEC obtained a $5-million penalty, the appointment of an ICC and the opportunity to deliver a message on programmatically important points, all while avoiding litigation risk. Deer Park and its CIO, meanwhile, obtained a settlement without a suspension or bar and without a fraud charge, which thereby appears to ensure that the business will continue with minimal disruption. To Deer Park, which has $2.5 billion in assets, the $5-million civil penalty was likely viewed as a small price to pay. Thus, while the SEC is sometimes criticized for taking a one-size-fits-all approach, Deer Park reflects that the SEC will compromise where risk justifies it.

Valuation As an Examination and Enforcement Priority

The Order highlights the importance of the SEC’s view of litigation risk in crafting any proposed settlement. As the SEC has stated publicly in other contexts, two of the most important factors when considering potential settlements are “litigation risk” and the “benefits of avoiding that risk.”[1] Thus, although the SEC rarely litigates against major institutions, the SEC’s perception of litigation risk shapes its bottom-line settlement position. Here, likely by articulating a credible litigation risk, Deer Park and its CIO were able to avoid fraud charges.

Important Takeaways for Practitioners

Although Deer Park is a product of unusual circumstances, there are three broader takeaways for practitioners who deal with valuation cases.

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Valuation continues to be a priority in the Commission’s exams. Indeed, the Deer Park case involved staff members from the SEC’s Office of Compliance Inspections and Examinations. Thus, compliance professionals should continue to be attentive when valuation issues are raised during the course of an exam.

For more recent valuation cases brought by the SEC, see “Improper Expense Allocations and Careless Valuation Practices Result in Nearly $4 Million in Fines and Disgorgement for BDC Adviser” (Jan. 10, 2019); “Failure by Fund Manager to Disclose Updated Valuation Data in Connection With an Offer to Purchase LP Interests Results in SEC Sanctions” (Dec. 6, 2018); and “SEC Sanctions Investment Adviser and Principals for Using Fund Assets to Help an Affiliate and for Using Improper Valuation Adjustments to Boost Returns” (Nov. 8, 2018).
Model Risk

Finally, valuation by model gives hedge funds flexibility, but it also creates risk if the relevant rules are not scrupulously followed. As referenced above, the failure in Deer Park was having a valuation process that relied heavily on models but that did not specifically address the calibration requirement in the rules or provide training on the need for calibration.

Charles D. Riely is a partner at Jenner & Block and is a former assistant regional director for the Division of Enforcement for the SEC with significant experience in all aspects of the federal securities laws.

Stephen L. Ascher is a partner at Jenner & Block and is co-chair of the firm’s Securities Litigation and Enforcement Practice. Ascher regularly assists hedge funds and associated individuals on a wide variety of issues.

Nicolas G. Keller is an associate at Jenner & Block.