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# Outside a Black Box: Court and Regulatory Review of Investment Valuations of Hard-to-Value Securities

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# OUTSIDE A BLACK BOX: COURT AND REGULATORY REVIEW OF INVESTMENT VALUATIONS OF HARD-TO-VALUE SECURITIES

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ABSTRACT

*Valuation is a critical function of investment advisers that has significant implications for both clients and advisers. One potential risk associated with valuation is that an investment adviser may abuse its position in valuing portfolio assets to accrue higher management and incentive fees to the detriment of clients. Although the valuation function may be viewed as an objective exercise, adviser valuations become subject to greater levels of discretion for hard-to-value securities, making determinations of adviser abuse less clear. Depending on the transparency of the adviser, the valuation process itself may become a black box to the client. Securities and Exchange Commission regulation of and enforcement actions over an investment adviser's valuations of securities and court review of private litigation have taken different approaches to address this problem. Although Securities and Exchange Commission matters address questions of whether an adviser has appropriately valued a particular security, the focus of many enforcement matters addresses the process an adviser used to reach a valuation determination. In contrast, private litigants are constrained by court views of valuations of hard-to-value securities within the context of the antifraud statutes. In many cases, courts have taken the position that such determinations are simply opinions of an adviser. This Article surveys these approaches and concludes that judicial scrutiny should focus on a process-driven approach for adviser valuations.*

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## INTRODUCTION

One of the most fundamental functions of any manager of an investment vehicle is to value the portfolio assets accurately. The valuation of the portfolio over time reveals the financial performance of the investment and typically determines the fees the manager receives. In many instances, the valuation function is easy to discern for the manager and easy to verify for the investor or advisory client because the portfolio is disclosed and the assets have readily verifiable market prices. However, many investment strategies incorporate thinly traded bonds, derivative instruments, and other securities that do not have transparent market prices. Further, private funds may contractually limit investor access to portfolio holdings and may provide themselves with wide latitude to value the assets.[1] In these instances, the United States Securities and Exchange Commission ("Commission" or "SEC") and its staff have recognized the potential for abuse on the part of investment managers, who have a natural incentive to increase the value of portfolio assets in order to reap more handsome fees and tout more attractive returns to prospective investors.[2] To address these

[1] The term "private fund" is used in the Advisers Act of 1940 and generally refers to hedge funds. Hedge funds have grown in prominence as an investment vehicle for sophisticated and institutional investors. For a description of the origin and general characteristics of hedge funds, see JACK D. SCHWAGER, MARKET SENSE AND NONSENSE: HOW THE MARKETS REALLY WORK (AND HOW THEY DON'T) 185–210 (2013).

[2] Valuation is "critically important" for all investment companies because, among other things, "investment managers who are compensated on the basis of net asset value or performance may be unduly compensated." Statement Regarding "Restricted Securities," Investment Co. Act Release No. 5847, Accounting Series Release No. 113, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,135 (Oct. 21, 1969) [hereinafter Statement Regarding "Restricted Securities"]. For a discussion of the context of ASR 113, which was focused on concerns of valuation practices in mutual funds, see Janet K. Smith, et al., *The SEC's "Fair Value" Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities,* 6 FORDHAM J. CORP. & FIN. L. 421, 426–28 (2001); *see also* David W. Grim, Deputy Dir., Div. of Inv. Mgmt., U.S. Sec. and Exch. Comm'n, Remarks to the Investment Management Institute 2013 (Mar. 7, 2013) (transcript available at https://www.sec.gov/News/Speech/Detail/Speech/1365171515032) [https://perma.cc/68LT-TX9W] (prepared by Norm Champ, Dir., Div. of Inv. Mgmt.). Besides overpaying the adviser, overvaluation of portfolio assets can have dilutive effects on the investors in the fund. In this scenario a shareholder that redeems would reap a windfall at the expense of shareholders who remained in the fund. Craig S. Tyle, SEC Interpretive Letter, 1999 WL

issues, the federal securities laws and the Commission have adopted a process-driven approach to scrutinize valuations of hard-to-value securities.[3]

The federal securities laws have attempted to address the conflict of interest inherent in a manager's valuation of investment assets particularly for registered investment companies that are subject to the Investment Company Act of 1940 ("Investment Company Act").[4] The statutes and rules of the Investment Company Act relating to valuation focus on general standards and procedures for valuation rather than issuing specific valuation guidelines for hard-to-value securities.[5] Separate from these statutes and rules, the Commission has provided guidance to registered investment companies in applying the valuation standards in the Investment Company Act to hard-to-value securities.[6]

In addition, more limited regulation exists for investment advisers registered under the Investment Advisers Act of 1940 ("Advisers Act")[7] who manage private funds. The Advisers Act provisions take the form of specific requirements that may influence an adviser's valuation, such as a requirement for annual audited financial

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35020116, 5 n.4 (Dec. 8, 1999), https://www.sec.gov/divisions/investment/guidance/tyle120899.htm [https://perma.cc/G734-YN7Z] [hereinafter Tyle, SEC Interpretive Letter].

[3] *See* Investment Company Act of 1940 § 15(c), 15 U.S.C. § 80a-15(c) (2015); *see also In re* Kornitzer Capital Mgmt. Inc., Investment Company Act Release No. 31,560, 2015 WL 1800393 (Apr. 21, 2015); *In re* Chariot Advisors, LLC, Exchange Act Release No. 72,541, Investment Advisers Act Release No. 3872, Investment Company Act Release No. 31,149, 2014 WL 2986899 at *3 (July 3, 2014).

[4] *See, e.g.*, 15 U.S.C. § 80-a(1)(b)(5) (2012) (stating "it is declared that the national public interest and the interest of investors are adversely affected ... when investment companies ... in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny").

[5] *See, e.g.*, 15 U.S.C. § 80a-2(a)(41); Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.2a-1-2 (2015); *id.* § 270.2a-4; Smith et al., *supra* note 2, at 422–23.

[6] *See* Statement Regarding "Restricted Securities," *supra* note 2; *see also* Accounting for Investment Securities by Registered Investment Companies, Investment Company Act Release No. 6295, Accounting Series Release No. 118, [1937–1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,140 (Dec. 23, 1970) [hereinafter Accounting for Investment Securities by Registered Investment Companies].

[7] *See* Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, Investment Advisers Act Release No. 1092 (Oct. 8, 1987).

statements or a surprise inspection that invariably touches on a fund's valuation.[8] In addition to specific requirements, the Advisers Act also contains general antifraud provisions, including one that focuses on an adviser's fiduciary obligations to a client.[9] Depending on an adviser's conduct, these provisions may reach an adviser's valuation.

For valuation disputes involving investors of private funds, the aggrieved investors are left to rely on the courts' interpretation of the federal securities antifraud statutes.[10] While these provisions are well suited to address situations of overtly fraudulent conduct, such as Ponzi schemes, they often fail to extend to situations when advisers utilize problematic valuation methodologies.[11] Courts have been reticent to extend antifraud concepts to an investment manager's valuation, setting significant barriers for plaintiffs to prevail, particularly for private fund investors in these situations.[12] Courts have treated valuations largely as opinions rather than statements of fact.[13] The implication of these cases is that a manager's valuation—while completely inaccurate—may remain impervious to legal scrutiny. In many respects, the court's treatment of the subject is better understood as an extension of the business judgment rule and the dilemma of having courts interject their views of value in a potentially complicated situation.[14] Despite these challenges, a better approach could be developed to afford courts a process-driven review of an adviser's valuation procedures that is more aligned with the Commission's approach.

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[8] *See* 17 C.F.R. § 275.206(4)-2 (clarifying that audit and surprise inspection provisions extend to advisers who maintain custody of the securities); *see also id.* § 275.206(4)-2(d)(2) (stating that custody is interpreted broadly to include "having any authority to obtain possession" of client funds or securities).

[9] *See* 15 U.S.C. § 80b-6 (2012).

[10] Private litigants often rely on the antifraud provisions in the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), particularly Section 10(b) and Rule 10b-5. *See* 15 U.S.C. §§ 77q–r, § 78j; 17 C.F.R. § 240.10b-5.

[11] *See, e.g.*, Fait v. Regions Fin. Corp., 655 F.3d 105, 108–11 (2d Cir. 2011); *In re* Lehman Bros. Sec. & ERISA Litig., 799 F. Supp. 2d 258, 311–12 (S.D.N.Y. 2011); Omaha Civilian Emps.' Ret. Sys. v. CBS Corp., 679 F.3d 64, 67–69 (2d Cir. 2012).

[12] *See* Wendy Gerwick Couture, *Opinions Actionable as Securities Fraud*, 73 LA. L. REV. 381, 381–94 (2013).

[13] *Id.*

[14] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87–90 (2004).

This Article explores the regulatory and legal framework for fund valuations of securities and concludes that the current approach inadequately protects investors. In Section I of this Article, I discuss the Investment Company Act and Advisers Act provisions that govern valuation, particularly as it relates to the concept of fair value. This section also surveys settled administrative proceedings brought by the Commission involving valuation related claims against registered funds. Section II provides a survey of case law addressing valuation issues with a focus on private funds. In Section III, I discuss the limitations of the current approach in the case law and suggest possible alternatives for addressing valuation disputes.

## I. THE INVESTMENT COMPANY ACT AND ADVISERS ACT

The legal framework for valuation issues in the federal securities laws is primarily in the Investment Company Act and the Advisers Act.[15] The Investment Company Act's provisions are designed to provide specific guidance to the valuation of registered funds' assets when those securities are easy to value.[16] A fund with a security that has a readily available market price must adopt that price in its valuation.[17] The Investment Company Act further dictates the timing of market quotations of a registered investment company's securities that assures that the valuation

[15] Other statutes, rules, and regulations sometimes become relevant to the valuation of assets in investment vehicles. For example, a public holding company that controls an investment adviser may have reporting and other obligations under the Exchange Act. *See, e.g.*, *In re* GLG Partners, Inc., Exchange Act Release No. 71050, 107 SEC Docket 4573, 4574 (Dec. 12, 2013) (settled matter) (finding adviser's overvaluation of assets in an investment portfolio also distorted filings of parent, a public company, leading to violations of Sections 13(b)(2)(B) and 13(b)(1)(A) and Rules 13a-1, a-11, and a-13 of the Exchange Act); *In re* KCAP Fin., Inc., Exchange Act Release No. 68,307, 105 SEC Docket 207, 207–08 (Nov. 28, 2012) (settled matter) (holding that a business development company failed to follow relevant accounting rules in valuation of assets violating Exchange Act provisions); s*ee also* Complaint at 1–6, SEC v. Brantley Cap. Mgmt., LLC, No. 1:09-CV-01906 (N.D. Ohio Aug. 13, 2009), [https://perma.cc/YCT5-PLH6]; SEC v. Brantley Cap. Mgmt., LLC, Litig. Release No. 21,178, 96 SEC Docket 1823, 1824 (Aug. 13, 2009) (describing settlement with listed business development company whose adviser affiliate misvalued portfolio assets, violating Exchange Act provisions).

[16] *See* 15 U.S.C. § 80a-2(41) (2012).

[17] *Id.*

of the underlying securities held by the registered investment company is timely.[18] However, for hard-to-value securities, the Investment Company Act relies on broader principles. The fund's board is charged with a good faith obligation to value such assets and to develop policies and procedures for such valuations.[19] Other provisions of the Investment Company Act require the investment company to disclose its valuation practices.[20] Securities enforcement matters against registered funds involving hard-to-value securities have tended to focus on situations where an abuse of the fund's stated valuation policies and procedures occurred.[21] While more technical violations of the Investment Company Act are sometimes implicated in these cases, they typically involve some aspect of fraud, either on the part of the adviser's employees or, less frequently, the board itself.[22]

The Advisers Act's provisions have varying applications. The antifraud provisions in the Advisers Act, for example, apply to all investment advisers, regardless of whether they are registered.[23] For registered advisers, all of the Advisers Act provisions reach advisers to both registered investment companies and private funds.[24] These provisions do not specifically touch the issue of asset valuation. However, various provisions, such as the antifraud provisions, prohibit advisers from making misleading statements

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[18] *See* 17 C.F.R. § 270.22c-1 (2015) (stating Rule 22c-1 of the Investment Company Act requires a minimum daily valuation).

[19] *See* Tyle, SEC Interpretive Letter, *supra* note 2, at 3–5.

[20] *See* Craig S. Tyle, SEC No-Action Letter, 2001 WL 436249 (Apr. 30, 2001), [https://perma.cc/V5AP-64KA] [hereinafter Tyle, SEC No-Action Letter].

[21] *See In re* UBS Global Asset Mgmt. (Americas), Inc., Investment Advisers Act Release No. 3356, Investment Company Act Release No. 29,920, 102 SEC Docket 3075, 3078 (Jan. 17, 2012); *see also In re* Morgan Asset Mgmt., Inc., Securities Act Release No. 9116, Exchange Act Release No. 61,856, Investment Advisers Act Release No. 3009, Investment Company Act Release No. 29,203, 98 SEC Docket 455, 456 (Apr. 7, 2010).

[22] *See supra* note 21.

[23] *See supra* note 7; *see also* 15 U.S.C. §§ 80b-6(1-2), (4) (2012); 17 U.S.C. 275.206(4)-8 (2012) (Sections 206(1-2), (4), and Rule 206(4)-8 of the Advisers Act). Other antifraud provision rules promulgated under Section 206(4) apply only to registered advisers. *See, e.g.*, 17 C.F.R. §§ 275.206(4)-1, -2 (2012) (note that none of these provisions, including Rule 206(4)-1 and Rule 206(4)-2, are available to private litigants).

[24] *See* 15 U.S.C. § 80b-2(a)(11) (clarifying that the investment adviser definition includes advisers to companies and private funds).

concerning a fund's asset valuation.[25] Other provisions set minimum disclosure standards for private funds that influence valuations in the fund's portfolio. For example, the custody rule may require private funds to issue audited financial statements if certain conditions are met.[26] However, the Advisers Act provides no explicit obligations regarding valuation or the process utilized to value any securities in the portfolio.[27] As a result, enforcement actions against private funds under the Advisers Act have focused invariably on fraudulent conduct, such as an adviser's affirmative knowledge that a fund's assets were intentionally mispriced.[28]

### *A. The Investment Company Act and Fair Value*

#### *1. Statutory Framework and Guidance*

The Investment Company Act ultimately places responsibility for valuation determinations on the board of directors of the fund. The board is required to develop policies and procedures that comply with the Investment Company Act's valuation provisions.[29] The primary provision governing valuation requires that, for a security with "readily available" market quotations, the fund is generally obligated to utilize the market quotation to value the security.[30] Alternatively, for "other securities and assets," the

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[25] *See* 15 U.S.C. § 80b-6; *see also* 15 U.S.C. § 80b-7.

[26] *See* 15 U.S.C. § 80b-6; *see also* 17 C.F.R. § 275.206(4)-2 (2015) (Section 206(4) and Rule 206(4)-2 of the Advisers Act).

[27] *See* 15 U.S.C. § 80b-4(b)(3)(D) (While this section of the Advisers Act requires that an investment adviser maintain valuation policies and practices of the fund, it does not specify what those policies and procedures should be); *see also* 17 C.F.R. § 275.204(2).

[28] *See, e.g.*, *In re* John Thomas Cap. Mgmt. Gr. LLC, Securities Act Release No. 9396, Exchange Act Release No. 69,208, Investment Advisers Act Release No. 3571, Investment Company Act Release No. 30,435, 105 SEC Docket 4051, 4051–55 (Mar. 22, 2013); Advisers Act Release No. 3571, 2013 WL 1180836 (Order Instituting Proceedings, filed Mar. 22, 2013) (partially settled matter, litigation ongoing).

[29] *See* Tyle, SEC Interpretive Letter, *supra* note 2, at 3–5.

[30] Section 2(a)(41)(B) of the Investment Company Act provides one exception to utilizing market prices to value portfolio assets. Money market funds may deviate from this requirement and instead use amortized cost under certain circumstances. 15 U.S.C. § 80a-2(41)(B). However, under Rule 2a-7, the Commission will scrutinize the use of fair value pricing if it is used to prop up or otherwise manipulate asset values. 17 C.F.R. § 270.2a-7; s*ee also In re* John

fund's board of directors determines "fair value" in "good faith."[31] Although the Investment Company Act appears to create two categories of securities relevant to valuation analysis, a fund's obligation to utilize fair value may include securities that typically have readily available quotations. For example, fair value may be appropriate for a widely traded foreign security if the foreign exchange on which it is traded is closed because of a scheduled market holiday and a value is needed for that date.[32] In addition, the fair value approach is often necessary for alternative mutual funds that hold hard-to-value securities.[33]

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E. Backlund, et. al, Securities Act Release No. 7626, Investment Advisers Act Release No. 1783, Investment Company Act Release No. 23,639, 68 SEC Docket 2663, 2665 (Jan. 11, 1999).

Additional provisions in the Investment Company Act touch on valuation considerations relevant to the valuation of the fund's shares. Rule 2a-4(a)(2) requires open-end mutual funds to reflect changes in its portfolio holdings no later than in the first calculation one business day following the trade date. 17 C.F.R. § 270.2a-4(a)(2). Rule 2a-4(a) defines "current net asset value" for shares issued by an open-end mutual fund. *Id.* § 270.2a-4(a). Rule 22c-1(a) states that a computation of the valuation of open-end mutual fund shares must be computed to reflect current net asset value after the receipt of a purchase or sale order. *Id.* § 270.22c-1(a). Rule 22c-1(b) specifies that an open-end mutual fund's net asset value must be calculated at least daily. *Id.* § 270.22c-1(b). Under § 23(b), closed-end mutual funds are not permitted to issue stock at prices below net asset value. 15 U.S.C. § 80a-23(b).

[31] See the definition of "Value" under Section 2(a)(41)(B) of the Investment Company Act. 15 U.S.C. § 80a-2(41)(B).

[32] *See* MUTUAL FUND DIRECTORS FORUM, REPORT OF THE MUTUAL FUND DIRECTORS FORUM: PRACTICAL GUIDANCE FOR FUND DIRECTORS ON VALUATION OVERSIGHT 3 (2012), http://www.mfdf.org/images/Newsroom/Valuation-web.pdf [http://perma.cc/5BGF-TD3T] (providing the example described, as well as other situations when an exchange-traded security might require fair value treatment).

[33] Until recently, the alternative mutual fund space was the fastest growing area in asset management. *See* Deidre Brennan, *Will Liquid Alts' Performance Sustain Future Asset Flows?*, FINALTERNATIVES 1 (Aug. 25, 2014) http://www.finalternatives.com/node/28088/print [http://perma.cc/7RYB-C9LW] (noting that although the segment made up 1 percent of the mutual fund industry (approximately $154 billion in assets under management), the segment grew by 43 percent in 2013). However, growth in the space has slowed considerably, and a growing number of funds have liquidated. *See* Joe Morris, *Liquidations Signal Turning Point for Alts,* IGNITES (Dec. 31, 2015). For valuation considerations related to these funds, see Norm Champ, Dir., Div. of Inv. Mgmt., Remarks to the Practising Law Institute, Private Equity Forum, (June 30, 2014),

The Commission provided guidance on the fair value and good faith concepts as they related to illiquid and hard-to-value securities over forty years ago in two releases.[34] The first release, issued in 1969, discussed situations when a fund board's approval of a valuation technique would fall short of good faith.[35] For example, in discussing the valuation of restricted securities,[36] the Commission stated that it was improper to fix the valuation at the market price or at a preset percentage discount from free trading securities of the same issuer, cost, or an amortization formula for various reasons.[37] The theme of the Commission's 1969 release was that there is "no automatic formula" to apply to such securities and that fund boards were obliged to continuously review restricted stocks "individually."[38]

One year later, the Commission issued additional guidance. The 1970 release emphasized that there was no single standard for determining which "fair value ... in good faith can be laid down since fair value depends on the circumstances of each individual case."[39] The Commission defined fair value as a value based on "the amount which the owner might reasonably expect to receive for them upon their current sale."[40] Rather than setting out a methodology for determining fair value in good faith, the 1970 release provides a number of relevant factors a fund board may consider in conducting a good faith valuation. Although not purporting

(transcript available at http://www.sec.gov/News/Speech/Detail/Speech/1370542253660) [http://perma.cc/S84V-X25J].

[34] *See* Statement Regarding "Restricted Securities," *supra* note 2, ¶ 72,135; *see also* Accounting for Investment Securities by Registered Investment Companies, *supra* note 6, ¶ 72,140.

[35] *See* Statement Regarding "Restricted Securities," *supra* note 2, ¶ 72,135.

[36] A party holding restricted stock is subject to limits on how or when the shares can be disposed. For example, Rule 144 of the Securities Act places a holding period and other restrictions on certain stock. Such stock is typically viewed as worth less than free trading stock in a variety of contexts. *See, e.g.*, John D. Finnerty, *The Impact of Stock Transfer Restrictions on the Private Placement Discount,* 42 FIN. MGMT. 575, 575–609 (2013); Daniel R. Van Vleet & Frank D. Gerber, *Valuing Restricted Stocks Issued in Acquisitions,* 35 MERGERS & ACQUISITIONS 36, 36–39 (2000).

[37] *See* Statement Regarding "Restricted Securities," *supra* note 2, ¶ 72,135.

[38] *Id.* at 5.

[39] S*ee* Accounting for Investment Securities by Registered Investment Companies, *supra* note 6, ¶ 72,140.

[40] *Id.* Some commenters have criticized fixing fair value on a current sale price because investors and the adviser may view the security on the basis of a future anticipated return. *See, e.g.*, Smith et al., *supra* note 2, at 426.

to be exhaustive, the factors for equity securities include fundamental analytical data relating to the investment, analyst reports, size of the holding, recent transactions, merger proposals or tender offers, and equities trading activity in comparable enterprises.[41]

Commission staff has periodically reiterated the Commission's guidance over a board's good faith obligation in making a fair value determination.[42] In the recent money market fund reforms implemented by the Commission in 2014, the Commission provided added guidance concerning the use of pricing services to obtain valuations of hard-to-value securities.[43] Although the use of such services is permissible, the board "may want to consider the inputs, methods, models, and assumptions used by the pricing service to determine its evaluated prices, and how those inputs, methods, models, and assumptions are affected (if at all) as market conditions change" before relying on those valuations.[44] The Commission outlined other considerations, such as "the quality of the evaluated prices provided by the service" and the proximity of time of the valuations to the time the fund calculates a net asset value.[45] The guidance also questioned "the appropriateness of using evaluated prices provided by pricing services as the fair values of the fund's portfolio securities" if "the fund's board of directors does not have a good faith basis for believing that the pricing service's pricing methodologies produce evaluated prices that reflect what the fund could reasonably expect to obtain for the securities in a current sale under current market conditions."[46]

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[41] *See* Accounting for Investment Securities by Registered Investment Companies, *supra* note 6, ¶ 72,140.

[42] *See, e.g.*, Tyle, SEC Interpretive Letter, *supra* note 2, at 7; Tyle, SEC No-Action Letter, *supra* note 20, at 8. (While noting that there is "no single standard" for determining fair value in good faith, "a board acts in good faith when its fair value determination is the result of a sincere and honest assessment of the amount that the fund might reasonably expect to receive for a security upon its current sale, based upon all of the appropriate factors that are available to the fund."). The Commission has also recently reiterated many of these basic principles in discussing its reforms to money market funds. *See* Money Market Reform; Amendments to Form PF, 79 Fed. Reg. 47,736, 47,814 (Aug. 14, 2014) [hereinafter Money Market Reform]. The Commission was explicit that its discussion of valuation covered all registered investment companies. *See id.* at 47,812, n.873.

[43] *See* Money Market Reform, *supra* note 42, at 47,813.

[44] *Id.* at 47,814.

[45] *Id.*

[46] *Id.* at 47,815.

U.S. Generally Accepted Accounting Principles ("U.S. GAAP"), which are often used by U.S. firms, provide further guidance on fair value, but do not formally distinguish between the two categories valuation set out in the Investment Company Act.[47] Instead, all securities are valued as "fair value" which is defined as an "exit price"—a "price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions."[48] U.S. GAAP identifies two general categories of possible inputs that may be relevant to valuing an asset. The first category, observable inputs, relies on existing market data that may be relevant to valuing the asset.[49] There is a further distinction in the treatment of observable inputs.[50] Publicly traded securities with large trading volumes often have market quotations that are an observable input.[51] U.S. GAAP treats a valuation that is derived from such unadjusted market quotations of the same asset as a Level 1 input.[52] For securities lacking market transactions, market prices for similar assets are an example of an observable

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[47] Although not explored in this Article, accountants also face liability concerning the audit of a fund's financial statements. Potential liability extends to an accountant's failure to follow proper accounting principles in the valuation of a security. The consequences for accountants who fail to follow applicable accounting guidance includes being barred from practicing before the Commission. *See, e.g.*, *In re* Lawrence A. Stoler, Securities Act Release No. 8726, Exchange Act Release No. 54,246, Investment Advisers Act Release No. 2539, 88 SEC Docket 1647, 1652 (July 31, 2006) (settled matter).

[48] FINANCIAL ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE: FAIR VALUE MEASUREMENT (TOPIC 820) 820-10-05-1B (May 2011), https://asc.fasb.org/imageRoot/00/7534500.pdf [http://perma.cc/Q587-SSGT] [hereinafter FINANCIAL ACCOUNTING STANDARDS]. International Financial Reporting Standards ("IFRS"), which is utilized by many funds domiciled in foreign jurisdictions, has a similar definition for fair value. *See* IFRS FOUNDATION, ILLUSTRATIVE EXAMPLES TO ACCOMPANY IFRS 13 FAIR VALUE MEASUREMENT 6 (Dec. 2012), http://www.ifrs.org/use-around-the-world/education/fvm/documents/educationfairvaluemeasurement.pdf [http://perma.cc/3JXH-ZFHC]. However, the two accounting regimes have varying approaches to the measurement of fair value. *See, e.g.*, FINANCIAL ACCOUNTING STANDARDS BD., *supra* at 7–8.

[49] *See* KPMG, FAIR VALUE MEASUREMENT: QUESTIONS AND ANSWERS 36 (Nov. 2013), http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/IFRS-Practice-Issues/Documents/fair-value-qa.pdf [https://perma.cc/UVZ4-B9AW].

[50] *See, e.g.*, *id.* at 3.

[51] *Id.* at 107.

[52] *Id.* at 36.

input.[53] U.S. GAAP treats the use of market quotations of similar assets as a Level 2 input.[54]

Unobservable inputs—the second category—reflects the use of assumptions that market participants may use to value the asset.[55] However, U.S. GAAP requires these assumptions be based on the best information available.[56] U.S. GAAP describes this form of valuation as a Level 3 input.[57] Because of the inherent subjectivity of unobservable inputs, observable inputs are preferred when they are available.[58] However, they may not be available for many types of assets, including distressed debt, bespoke derivatives, or private equity investments.[59]

Boards may delegate aspects of the valuation function to other parties. Funds often retain third party valuation services to value fund securities and may designate a valuation committee that consists primarily of non-board members to oversee the valuation functions of the fund.[60] Although the Commission allows these forms of delegation, the ultimate responsibility for fund valuations falls on the board.[61]

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[53] *Id.* at 43–44.

[54] *Id.* at 5.

[55] *Id.* at 22.

[56] *Id.* at 23.

[57] *Id.* at 36.

[58] *Id.* at 46.

[59] *See* PRICEWATERHOUSECOOPERS FINANCIAL SERVICES, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 157—FAIR VALUE MEASUREMENTS 3, http://www.pwc.com/bm/en/publication/assets/usgaap_08_04.pdf [https://perma.cc/U5EP-7CZC].

[60] MUTUAL FUND DIRS. FORUM, PRACTICAL GUIDANCE FOR FUND DIRECTORS ON VALUATION OVERSIGHT 10 (2012), http://www.mfdf.org/images/Newsroom/Valuation-web.pdf [https://perma.cc/HED4-8A85].

[61] The Commission has repeatedly emphasized that boards cannot delegate the ultimate responsibility for determining the fair value of fund assets. For example, the Commission has stated:

> [I]t is incumbent upon the Board of Directors to satisfy themselves that all appropriate factors relevant to the value of securities for which market quotations are not readily available have been considered and to determine the method of arriving at the fair value of each such security. To the extent considered necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board's direction. The board must also, consistent with this responsibility, continuously review the appropriateness

The board's obligations regarding valuation under the Investment Company Act are process-driven and relate to the development of sound valuation policies and procedures rather than a fund's estimate of value to any particular security. For example, Rule 38a-1 of the Investment Company Act requires each registered fund to "[a]dopt and implement written policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by the fund."[62] It is incumbent on the board to develop valuation policies and procedures that: (a) monitor the necessity of using fair value prices and develop criteria to determine when market quotations are not an appropriate value; (b) implement a methodology to fair value assets in the fund; and (c) regularly review the valuation methodology of the fund and implement adjustments as needed.[63] Fund boards are also required to review the adequacy of the policies and procedures of service providers, such as the adviser to the fund, principal underwriter, administrators and transfer agents.[64]

The threshold issue a board confronts is whether a market quotation is not an appropriate measure of the value of the security held in the fund's portfolio.[65] Commission staff has explicitly stated that boards should "carefully consider various indications of the validity and reliability of market quotations" for domestic securities.[66]

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> of the method used in valuing each issue of security in the company's portfolio. The directors must recognize their responsibilities in this matter and whenever technical assistance is requested from individuals who are not directors, the findings of such individuals must be carefully reviewed by the directors in order to satisfy themselves that the resulting valuations are fair.

Accounting for Investment Securities by Registered Investment Companies, *supra* note 6, ¶ 72,140; *see also In re* Seaboard Assoc., Inc., Exchange Act Release No. 20,867, Investment Company Act Release No. 13,890, 30 SEC Docket 330, 334–35 (Apr. 16, 1984) (Commission Section 21(a) Report); *In re* Hammes, et. al, Securities Act Release No. 8346, Investment Company Act Release No. 26,290, 81 SEC Docket 2467, 2472 (Dec. 11, 2003) (settled matter) (quoting *In re* Hartl & Lipman, Securities Act Release No. 7031, Exchange Act 33,165, Investment Company Act Release No. 19,840, 55 SEC Docket 991, 994-94 (Nov. 8, 1993)); Tyle, SEC No-Action Letter *supra* note 20, at 8 n.23.

[62] Rules and Regulations, Investment Company Act of 1940, 17 C.F.R. § 270.38a-1(2006) [hereinafter Rules and Regulations, Act of 1940].

[63] Compliance Programs of Inv. Co. and Inv. Advisers, 68 Fed. Reg. 74,714, 74,718 (Dec. 24, 2003) (codified as 17 C.F.R. §§ 270, 275, 279).

[64] *See supra* note 62 and accompanying text.

[65] *See* KPMG, *supra* note 49, at 39.

[66] Tyle, SEC No-Action Letter, *supra* note 20, at 3.

A thin market for a security or widely varying quotations from broker-dealers might be indicative of the need for fair value pricing. Funds, often with the assistance of third party pricing services, identify triggering events that support using fair value pricing.[67] Once such an event occurs, the fund's board exercises its judgment to determine whether using fair value is appropriate.[68] The board would then likely retain a third party to conduct the valuation.[69]

As noted, a fund's board is required to adopt policies and procedures with respect to valuation.[70] Fair value is likely a significant aspect of these policies and procedures, which should include a description of the methodology for a fair value determination.[71] The adviser to the fund, who is responsible for managing the portfolio, will follow the methodology outlined in the procedures. The methodology should contain a hierarchy of the source for a fair value determination.[72] The appropriate valuation source may be varied based on the type of security to be valued.[73] When implemented properly, the procedures should demonstrate that the adviser is consistently using fair value procedures across the fund's portfolio.[74]

A fund board's responsibility does not end with a one-time adoption of valuation policies and procedures—Commission staff has stated that the board should "periodically review the appropriateness of the methods used to fair value price portfolio securities and the quality of the prices obtained through these procedures, and ... make changes when appropriate."[75] One aspect of this responsibility—monitoring—requires the board to determine what

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[67] MUTUAL FUND DIRS. FORUM, *supra* note 60, at 5. Funds often set a trigger that is "a percentage of the daily change in the value of an index of domestic securities between the time of the close of a foreign exchange and the close of the NYSE." *Id.*

[68] *Id.*

[69] *Id.*

[70] *See* 68 Fed. Reg. 74,718.

[71] *Id.*

[72] *See* MUTUAL FUND DIRS. FORUM, *supra* note 60, at 5.

[73] *See id.*

[74] *See id.*

[75] *See* Tyle, SEC Interpretive Letter, *supra* note 2, at 7. An older Commission 21(a) Report used stronger language, emphasizing the board's continuous review of valuation methods:

> While the Commission recognizes the difficulties inherent in the valuation of [such] interests, directors have an affirmative

documentation is necessary to evaluate whether the investment adviser is following the fund's valuation policies and procedures.[76]

The Mutual Fund Directors Forum has outlined common board best practices to address valuation issues.[77] Boards sometimes appoint a member to act as a liaison to communicate with the valuation committee or other relevant parties on difficult valuation issues.[78] During the monitoring process, the board may become apprised that a particular valuation policy or procedure is no longer appropriate for a variety of reasons and, therefore may wish to consider revising its policies and procedures. Boards may also adopt a more formalized approach, periodically conducting a review of all valuation policies and procedures and obtaining the input of other relevant parties—counsel, auditors, and other valuation experts.[79] The review process sometimes also incorporates a risk-based analysis to determine the robustness of the fund's valuation policies and procedures under different scenarios.[80]

Although less relevant to the valuation process itself, the Investment Company Act also regulates the liquidity of open-end mutual funds.[81] The liquidity regulations, however, may have the effect of reducing the amount of hard-to-value securities present

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> responsibility to keep informed of developments which materially affect those assets not having a readily ascertainable market value .... Consistent with this responsibility, the directors of a registered investment company must continuously review the appropriateness of the method used in valuing the asset not having a readily ascertainable market value.

*In re* Seaboard Assoc., Inc., Exchange Act Release No. 20,867, Investment Company Act Release No. 13,890, 30 SEC Docket 330, 334–35 (Apr. 16, 1984).

[76] Board monitoring of adviser valuations as well as maintaining adequate documentation to support that oversight are derived from Rule 38a-1(a)(3) and (d) of the Investment Company Act. *See* Rules and Regulations, Act of 1940, *supra* note 62. Commission guidance has suggested continuous review of the valuation policies. *See* Statement Regarding "Restricted Securities," *supra* note 2, ¶ 72,135. Further, the 1970 release notes that the information a board considered in reaching a fair valuation determination "should be documented in the minutes of the directors' meeting and the supporting data retained for the inspection of the company's independent accountant." *Id.*

[77] *See* MUTUAL FUND DIRS. FORUM, *supra* note 60, at 2.

[78] *See id.* at 6.

[79] *See id.*

[80] *See id.* at 6–8.

[81] *See generally* Investment Company Act of 1940 § 22, 15 U.S.C. § 80a-22 (2012).

in certain registered investment companies. For example, the Investment Company Act requires that such funds satisfy redemption requests within seven days of the request.[82] Commission staff have provided related guidance that open-end funds should not hold more that 15 percent of the net assets in illiquid securities.[83] And, the guidance defines an illiquid security as one that cannot be disposed of in the ordinary course of business within seven days at approximately the value of which the fund has valued the investment on its books.[84] Therefore, an important consideration in assigning a value of a portfolio security is whether the open-end fund can dispose of that asset within the seven-day timeframe.[85]

An analog concept that appears throughout the securities laws—the concept of disclosure—is also relevant to fund valuations and consistent with the process-driven approach toward valuation issues.[86] The Investment Company Act requires fund transparency of valuation policies in periodic filings.[87] For example, open-end mutual funds are required to file registration statements that include disclosures regarding the methodology to value securities in the fund's portfolio, the circumstances under which a fund may use fair value rather than market quotations, and the effect on the fund of using market quotations.[88] There are similar requirements to disclose "the methods used in determining value of investments" of a fund in periodic financial statements.[89] Failure to accurately value the securities or follow a fund's stated valuation procedures can lead to violations of Section 34(b) of the Investment

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[82] *Id.* § 80a-22(e).

[83] *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992) (to be codified at 17 C.F.R. pts. 239, 274). Some authors had historically suggested that registered funds did not fully take advantage of holding illiquid securities up to the 15 percent limit because of onerous fair value requirements. *See* Smith et al., *supra* note 2, at 460–61. However, the growth of registered funds pursuing liquid alternative strategies may undermine such a critique. *See* Brennan, *supra* note 33.

[84] *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. at 9829.

[85] *Id.*

[86] *See generally* Investment Company Act, 15 U.S.C. § 80a (2012).

[87] 17 C.F.R. § 271.11A (1984).

[88] *Id.* § 8(b). One disadvantage of these filings, however, is the possibility that they may become stale if the board changes the fund's valuation methodology.

[89] *See* Special rules of general application to registered investment companies, 17 C.F.R. § 210.6-03(d) (1994).

Company Act that prohibits funds from disclosing materially misleading information in any required Commission filing.[90]

### *2. Commission Enforcement Actions*

Commission enforcement actions involving registered funds for valuation issues unsurprisingly tend to focus on failures and abuses of the fund's valuation policies and procedures. These matters typically involve situations where the fund failed to follow its stated valuation procedures.[91] They largely occur in situations where a fund's portfolio is losing value and a portfolio manager attempts to manipulate the fund's valuation procedures to hide the losses.[92] In many of these cases, the Commission does not charge the fund's board since it was deceived.[93]

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[90] *See* 15 U.S.C. § 80a-33(b) (2012).

[91] *See, e.g.*, *In re* Equinox Fund Mgmt., LLC, Securities Act Release No. 10,004, Exchange Act Release No. 76,927, Investment Advisers Act Release No. 4315, 2016 WL 212680 (Jan. 19, 2016) (settled matter); *In re* UBS Global Asset Mgmt. (Ams.) Inc., Investment Advisers Act Release No. 3356, Investment Company Act Release No. 29,920, 102 SEC Docket 3075, 3076–78 (Jan. 17 2012) (settled matter); *In re* Morgan Asset Mgmt., Inc., et al., Securities Act Release No. 9116, Exchange Act Release No. 61,856, Investment Advisers Act Release No. 3009, Investment Company Act Release No. 29,203, 98 SEC Docket 455, 456 (Apr. 7, 2010) (settled matter); *In re* Piper Cap. Mgmt., Inc., et al., Securities Act Release No. 8276, Exchange Act Release No. 48,409, Investment Advisers Act Release No. 2163, Investment Company Act Release No. 26,167, 80 SEC Docket 2772, 2779, 2781 (Aug. 26, 2003) (settled matter); *In re* Kyle R. Kirkland, Securities Act Release No. 8019, Exchange Act Release No. 44,876, Investment Advisers Act Release No. 1982, Investment Company Act Release No. 25,199, 75 SEC Docket 2242 (Sept. 28, 2001) (settled matter).

[92] However, there are situations where an adviser may undervalue a portfolio. For example, in *Van Wagoner*, a portfolio manager of a fund complex undervalued illiquid securities holdings. *See In re* Van Wagoner, Investment Advisers Act Release No. 2281, Investment Company Act Release No. 26,579, 83 SEC Docket 1955, 1957 (Aug. 26, 2004) (settled matter). The funds' offering materials disclosed that the funds would not acquire illiquid securities if the acquisition raised any fund's holdings of illiquid securities above 15 percent of the value of the relevant fund. *Id.* In the settled matter, the Commission alleged that the portfolio manager wrote down the value of certain private securities holdings to zero in order to acquire more private securities. *Id.* Although the offering materials stated that the funds would determine the fair value of such securities, the portfolio manager failed to do so. *Id.* at 1959–60. The order stated that the portfolio manager "failed to fair value the securities in good faith ... [and] failed to follow the board's fair valuation policies, which did not permit the write-down in securities' valuations in an effort to shrink the entire portfolio." *Id.*

[93] *Id.* at 1955, 1959, 1961.

The *Morgan Asset Management*,[94] administrative proceeding and related *J. Kenneth Alderman*[95] proceeding represent recent matters that address the adviser's role in accurately valuing hard-to-value securities and the board's role in setting appropriate policies and procedures related to the valuation process. In *Morgan Asset Management*, the Commission, focusing on a fund's adviser, alleged that the adviser's staff intentionally inflated the value of certain illiquid securities in five funds.[96] The assets were subprime mortgage-backed bonds.[97] The effect of the mispricing was to understate the significant price declines those securities experienced and understate portfolio losses in the funds.[98] In addition to charging various violations of the antifraud statutes,[99] the order charged the respondents with failing to implement adequate policies and procedures related to valuation practices and for failing to comply with the requirements in Rule 22c-1 of the Investment Company Act, which requires funds to sell and redeem shares based on current net asset values.[100]

The funds' boards of directors delegated the valuation function to the adviser, Morgan Asset Management, Inc. ("Morgan Asset").[101] Morgan Asset priced each portfolio's securities, calculated a daily net asset value for the fund and largely staffed the funds' valuation committees.[102] The funds' prospectus detailed the valuation

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[94] *See In re Morgan Asset Mgmt.*, 98 SEC Docket at 456 (Apr. 7, 2010). The matter subsequently settled. *See In re* Morgan Asset Mgmt., Inc., Exchange Act Release No. 64,720, Investment Advisers Act Release No. 3218, Investment Company Act Release No. 29,704, 2011 WL 2482883 (June 22, 2011).

[95] *See In re* J. Kenneth Alderman, et al., Investment Company Act Release No. 30,557, 106 SEC Docket 2376 (June 13, 2013) (settled matter).

[96] *See In re Morgan Asset Mgmt.*, 98 SEC Docket at 456, 459.

[97] *Id.* at 456.

[98] *Id.* at 456, 458.

[99] The order cited violations of the general antifraud provisions in Section 17(a) of the Securities Act of 1933, Section 10(b) and Rule 10b-5 of the Exchange Act of 1934, and the advisory antifraud statutes of Sections 206(1) and 206(2) of the Advisers Act of 1940. *Id.* at 459. In addition, the order cited violations of Section 34(b) of the Investment Company Act of 1940, which prohibits misleading statements in certain filings. *Id.*

[100] The order charged violations of policies and procedures provisions in both the Investment Company Act (Rule 38a-1) and the Advisers Act under Section 206(4) and Rule 206(4)-7. *See id.* at 459–60.

[101] *Id.* at 456.

[102] *Id.* at 456–57.

process when market quotations were not available.[103] In those situations, fair value was determined through various factors including the use of "fundamental analytical data," "an evaluation of the forces which influence the market in which the securities are purchased or sold," and "events affecting the security."[104] The policies and procedures also required the funds' valuation committees to maintain documentation of the manner fair value was determined for a security.[105] In addition, to support the fair value, each committee was required to maintain the next reliable quote for the fair valued security.[106]

The Commission alleged that Morgan Asset failed to comply with the funds' valuation policies and procedures in several respects. First, the funds' valuation committees "left pricing decisions to lower level employees ... who did not have the training or qualifications to make fair value pricing determinations."[107] The Commission also alleged that the valuation committees failed to review fair valuations of securities periodically, allowing them to be carried in the portfolio at "stale values for many months at a time."[108] The Commission's main allegations revolved around the activities of a portfolio manager of the funds. The manager provided 262 "price adjustments" to illiquid mortgage-backed securities that were unsubstantiated and he was given too much discretion to select which broker-dealer quotes would be used to substantiate the valuations or whether they were overridden entirely.[109]

The portfolio manager's conduct was particularly egregious in *Morgan Asset*. The Commission alleged that he had conversations with one broker-dealer employee that was providing indicative quotes for the illiquid securities to the funds' auditor and Morgan Asset's accounting department.[110] The portfolio manager requested the employee increase the broker-dealer's quotes as an accommodation to avoid having to mark down the fair value of the securities that the manager had assigned.[111] For example, the

[103] *Id.* at 457.
[104] *Id.* at 456.
[105] *Id.*
[106] *See id.*
[107] *Id.* at 457.
[108] *Id.* at 457–58.
[109] *Id.* at 457.
[110] *Id.* at 456, 458.
[111] *Id.* at 458.

portfolio manager had marked down a mortgage-backed security from $78 to $72.[112] A few days later, the broker-dealer's trading desk provided a value of the same security at $50.[113] However, the portfolio manager persuaded the broker-dealer employee to provide an "interim" quote of $65, substantially overstating the value of the security.[114] In other instances, the portfolio manager also persuaded the broker-dealer not to provide the funds' auditor and Morgan Asset's accounting department a quotation.[115]

In *Alderman*, which named eight directors as respondents, focused on the board's role in setting appropriate policies and procedures to value portfolio securities for the funds Morgan Asset advised.[116] The settled action simply alleged a violation of Rule 38a-1 of the Investment Company Act.[117] The Morgan Asset fund complex invested heavily in below investment grade debt securities that required fair value pricing.[118] In practice, the accounting department of the adviser set fair values based on a sample of indicative quotes from brokers.[119] As these assets experienced an abrupt decline in value, the portfolio manager overrode the valuations and smoothed the losses.[120] For example, the portfolio manager "gradually reduce[d], over days or weeks, a bond to its current proper valuation."[121] As discussed previously, Morgan Asset's conduct violated the policies and procedures in place for the funds.[122]

Although the fund complex had policies and procedures in place, which cited commonly accepted factors to fair value securities, the administrative order alleged that they were inadequate and created the conditions that permitted the flawed security values.[123] The policies and procedures did not provide a "meaningful

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[112] *Id.*

[113] *Id.*

[114] *Id.*

[115] *Id.*

[116] *See In re* Alderman, et al., Investment Company Act Release No. 30,557, 106 SEC Docket 2376, 3280–81 (June 13, 2013).

[117] *Id.* at 2381.

[118] *Id.* at 2376–77.

[119] The administrative order emphasizes that the broker quotes were not firm quotes—in other words, quotes of prices at which the broker would actually buy the securities rather than opinions of value. *Id.* at 2378.

[120] *Id.* at 2378–79.

[121] *Id.* at 2379.

[122] *See supra* notes 107–15 and accompanying text.

[123] *Alderman*, 106 SEC Docket at 2378.

methodology or other specific direction on *how* to make fair value determinations for specific portfolio assets or classes of assets."[124] In particular, the policies and procedures lacked guidance on how to weigh each valuation factor.[125] The policies and procedures also failed to define critical terms in their valuation guidance, such as what constitutes "fundamental analytical data" for valuation purposes, and there was no mechanism to further review potentially stale fair values.[126] Additionally, no directors were members of the valuation committee, and the guidelines did not require the committee to report to the board the valuation methodology used to fair value the securities.[127] The order highlighted the board's obligation to set such policies and procedures in situations where the board does not directly make valuations itself:

> In connection with determining fair values, the Directors did not calculate the valuations themselves, and neither established clear and specific valuation methodologies nor followed up their general guidance to review and approve the actual methodologies used and the resulting valuations. Instead, they approved policies generally describing the factors to be considered but failed to determine what was actually being done to implement those policies. As a result, Fund Accounting implemented deficient procedures, effectively allowing the Portfolio Manager to determine valuations without a reasonable basis.[128]

Another strand of cases involves situations where the investment adviser and portfolio manager are confronted with information that raises doubts about the accuracy of the fund's stated asset valuations. These "red flag" cases often include other misconduct that raises some doubt on the accuracy of the adviser's valuation practices. For example, in *Evergreen Investment Management Company*, also a settled administrative action, the adviser allegedly failed to apprise the fund's valuation committee of negative information concerning certain mortgage-backed securities held in the fund.[129]

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[124] *Id.*
[125] *Id.*
[126] *Id.*
[127] *Id.*
[128] *Id.* at 2381.
[129] *In re* Evergreen Inv. Mgmt. Co., Exchange Act Release No. 60,059, Investment Advisers Act Release No. 2888, Investment Company Act Release No. 28,759, 96 SEC Docket 118 (June 8, 2009); *see also In re* Lisa B. Premo, Investment Advisers Act Release No. 3355, Investment Company Act Release

An example of a red flag occurred when the adviser learned that the issuer of a portfolio security would no longer pay out cash flow to the fund until a senior tranche of the security had been fully repaid to other investors.[130] The adviser failed to pass this information on to the valuation committee for some time.[131] When the committee learned about the situation, it marked down the value of the security to zero, reducing the fund's net asset value from $9.05 to $8.95 per share.[132] The change in net asset value ("NAV") was significant because the volatility of the fund was very low, fluctuating between $9.20 and $9.73 for the previous year.[133]

In another red flag cited in the administrative order, the adviser's portfolio management team received a dealer quote, which was substantially below the fund's previous valuation of a security.[134] A member of the team contacted the broker to determine whether the quote was based on a "distressed" sale.[135] If the transaction involved a distressed sale, the portfolio manager could arguably justify overriding the dealer's quote and maintaining a higher valuation to the valuation committee.[136] However, the broker informed the portfolio management team that the security was "'not coming from a distressed seller, just one that wanted to get out.'"[137] Nonetheless, the portfolio management team misinformed the fund's valuation committee "that they believed the sale was distressed and did not disclose the broker-dealer's statement."[138] As a result, "at least in part" of this misinformation, the valuation committee declined to mark the security down, overriding the quote.[139]

*Evergreen*, however, is not purely a red flags case. The matter also involved alleged selective disclosure of information, which compounded the impact of the fund's overvaluation.[140] After some time, the valuation committee of the fund decided to stop utilizing

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No. 29,919, 2012 WL 1029026 (Jan. 17 2012) (settled matter involving related charges against portfolio manager of Evergreen funds).

[130] *Evergreen*, 96 SEC Docket at 121.

[131] *Id.*

[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *Id.* at 123.

price overrides.[141] This action resulted in a series of downward revisions of the prices of the portfolio securities.[142] The revisions were not simultaneous and, as the fund's securities began to experience mark downs, the fund's distributor recognized that it would receive inquiries from clients and other interested parties.[143] The distributor prepared talking points for such inquiries.[144] The talking points disclosed that the fund might continue to mark down securities in the portfolio.[145] In addition to these talking points, the fund's distributor later contacted affiliated registered representatives to inform them of the situation and suggested that their clients could transfer their holdings to other funds in the fund complex.[146] These disclosures advantaged the investors who received this material information since they now knew that the fund likely faced additional downward revisions of NAV.[147]

Although less common, the Commission has brought other actions beside *Alderman* against fund boards.[148] In *Hammes*, a settled administrative action, the Commission alleged that two bond funds that were overseen by a common board were fraudulently mispriced.[149] The Commission's action focused liability on a subset of the funds' board—the members of the funds' audit committee.[150] The Commission alleged that they "failed adequately to assure that those bonds were priced at 'fair value' or adequately to monitor and assure the bonds' liquidity."[151] The order included charges of

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141 *Id.* at 121.

142 *Id.* at 122.

143 *Id.*

144 *Id.*

145 *Id.*

146 *Id.*

147 *Id.* at 123.

148 *See, e.g.*, *In re* Cornerstone Cap. Mgmt., Inc., Investment Advisers Act Release No. 2778, Investment Company Act Release No. 28,380, 94 SEC Docket 315 (Sept. 16, 2008) (settled matter); *In re* Hammes, Securities Act Release No. 8346; Investment Company Act Release No. 26,290, 81 SEC Docket 2467, 2468 (Dec. 11, 2003).

149 *Hammes*, 81 SEC Docket at 2468. A related case included charges against the funds' adviser, members of the pricing committee, and other employees of the adviser. *See In re* Heartland Advisors, Inc., Securities Act Release No. 8884, Exchange Act Release No. 57,206, Investment Advisers Act Release No. 2698, Investment Company Act Release No. 28,136, 92 SEC Docket 1306, 1306–07 (Jan. 25, 2008) (settled matter).

150 *Hammes*, 81 SEC Docket at 2468.

151 *Id.*

the Securities Act's antifraud provisions in Section 17(a)(2) and 17(a)(3).[152] The charges were based on five types of conduct perpetrated by board members: (1) they failed to monitor the liquidity of the securities to ensure the funds could meet shareholder redemptions; (2) they "passively rel[ied]" on valuation committee valuations; (3) they failed to "review financial statements, reports, contracts, and other documents relevant to the financial condition[s]" of a portfolio security; (4) they "failed to take adequate steps to follow up on their requests for information" from the adviser; and (5) they improperly applied a generic haircut to securities in lieu of conducting a fair value estimation.[153] In addition, the order charged the board members with causing violations of Rule 22c-1(a) of the Investment Company Act because the misvalued securities were an inaccurate reflection the funds' current NAV.[154]

The recitation of events in the *Hammes* order suggests the board was extraordinarily inept at handling worsening conditions at the funds.[155] Taken in isolation, each board action may not have amounted to a violation, but in its totality, the board's course of conduct was ample justification for charges. At various meetings the board was notified that the funds' portfolio of bonds was deteriorating.[156] In one meeting, the board was informed that the funds were having difficulty liquidating bonds to meet redemptions, relying heavily on the funds' credit line to meet obligations.[157] In another meeting, the board was informed that one fund held 18 percent of its portfolio in illiquid bonds and the other fund held 6 percent.[158] As the board received this negative information, they requested a report from the adviser explaining any plans to work out the bonds, as well as quarterly progress reports.[159] Despite continued deteriorating conditions, the Commission noted that the board failed to follow through on these requests since the adviser never completed the reports.[160]

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[152] *Id.* at 2472.

[153] *Id.* The order noted that the adviser also directly violated these statutes. *Id.*

[154] *Id.* The order noted that the adviser perpetrated a direct violation of Rule 22c-1. *Id.*

[155] *Id.*

[156] *Id.* at 2469–71.

[157] *Id.* at 2469.

[158] *Id.*

[159] *Id.* at 2470.

[160] *Id.*

Conditions for the bonds in the funds continued to worsen. The funds struggled to meet redemption requests since many of the bonds were illiquid.[161] In order to address the situation, the adviser sold some of the distressed bonds to another party.[162] The transaction price, however, was below the valuation of the bonds in the funds.[163] In order to close the transaction, the president of the adviser personally guaranteed to the counterparty that it could "put" the bonds back to an affiliate.[164] The transaction provided the counterparty with a guaranteed 20 percent annual return.[165] After the transaction, the adviser marked down the bonds in the portfolio further.[166] These mark downs were still not reflective of market conditions since the adviser "refused or failed to sell sufficient bonds held by the [f]unds to meet redemption requests, in large part because [the adviser] refused to value and sell the [f]unds' bonds at prices it could reasonably expect to receive in a current sale of those bonds."[167]

Four days after the transaction, the board found that well over half of the funds' remaining portfolios were illiquid.[168] Despite advice from the board's counsel that the securities should be assigned fair value rather than utilizing a pricing service, the board failed to instruct the pricing committee to fair value the bonds.[169] The following day, however, the pricing committee began the process of re-pricing the bonds using fair value.[170] The order noted prices were not changed retroactively for the previous trading day.[171] However, once the board received the fair values provided by the pricing committee, it applied uniform "haircuts" on the proposed fair values.[172] The haircuts were applied "without determining whether such a haircut was appropriate for each portfolio security" and the new values for the securities violated the board's

[161] *Id.* at 2471.
[162] *Id.* at 2470.
[163] *Id.*
[164] *Id.*
[165] *Id.*
[166] *Id.* at 2470–71.
[167] *Id.* at 2471.
[168] *Id.*
[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] *Id.*

obligation to "fair value" securities when market quotations were not available.[173]

Enforcement matters that squarely address an adviser's methodology as falling outside the standards set in the Investment Company Act or Commission guidance are extremely rare.[174] The *Parnassus Investments* matter, in which the Commission charged the adviser and board members of the fund, is the most recent matter, and represents, unsurprisingly, a fairly egregious fact pattern.[175] In *Parnassus*, the adviser managed an open-end mutual fund that followed a contrarian investment strategy.[176] One investment in the portfolio was a stock position in a financially troubled company, Margaux.[177] Margaux declared bankruptcy.[178] Although the fund held Margaux common stock prior to the bankruptcy, the adviser concluded that Margaux was undervalued and purchased more common stock as well as loaned an additional $100,000 to the company.[179] The adviser understood that the loan had a conversion right, but the loan agreement did not contain any such language, making the conversion right subject to approval by the bankruptcy court.[180] Margaux's financial problems persisted and the company was delisted, ultimately becoming a thinly traded over-the-counter stock.[181] After several setbacks, the company ceased operations.[182]

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[173] *Id.* at 2472.

[174] *See* Grim, *supra* note 2 (discussing review of methodologies depends on the situation and circumstances).

[175] *In re* Parnassus Invs., Accounting and Auditing Enforcement Release No. 1071, 67 SEC Docket 2013 (Sept. 3, 1998) (default order); *In re* Parnassus Invs., Exchange Act Release No. 40,534, 68 SEC Docket 364 (Oct. 8, 1998) (Notice that Initial Decision Has Become Final). Besides the valuation component of *Parnassus*, the adviser's conduct touched on other issues. The adviser invested outside its stated investment policy, limiting loans to repurchase agreements, by extending a direct loan to a company in violation of Sections 13(a)(3) and 21(a) of the Investment Company Act. In addition, the adviser's soft dollar practices violated Section 17(e)(1) of the Investment Company Act, as well as related disclosure violations under Section 207 of the Advisers Act. *See id.* at 364–65.

[176] *Parnassus Invs.*, 67 SEC Docket at 2014.

[177] *Id.* at 2014–15.

[178] *Id.*

[179] *Id.* at 2015.

[180] *Id.*

[181] *Id.* at 2016–17.

[182] *Id.* at 2019.

Beginning with the bankruptcy, the adviser in *Parnassus* took steps, with the approval of the board, to value the Margaux holding contrary to Rule 22c-1 of the Investment Company Act and the Commission's guidance in the Accounting Series Releases for good faith valuation of a security. [183] First, the adviser valued the loan as if it was converted to restricted stock and eventually added a 10 percent premium to the restricted shares.[184] The administrative law judge cited ASR 113 and quoted Commission guidance that restricted stock typically should hold a discount to free trading stock "except for the most unusual circumstances."[185] The administrative law judge concluded a significant discount was appropriate because, after the delisting, Margaux's stock was thinly traded, presenting significant liquidity concerns.[186]

Second, after the Margaux shares were delisted, the *Parnassus* adviser began to fair value the fund's common stock holdings.[187] The adviser valued the securities based on Margaux being a potential acquisition target.[188] The administrative law judge observed that the adviser and board did not identify any unusual circumstances justifying a departure from discounting the restricted stock right.[189] The judge also noted the adviser's "valuation methodology clearly accorded great weight to certain intangibles" including the firm's management, "innovative technology," and relationship with its primary customer.[190] Enforcement staff described the adviser's fair valuation approach as a "'long-term sale of the company approach,'" inconsistent with seeking the current value of the holding under Rule 22c-1.[191]

In concluding that the adviser's approach overvalued the Margaux common stock holding, the administrative law judge drew on the factors identified in ASR 118 for fund boards to consider in reaching a fair value of a security.[192] The judge concluded that the

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[183] *Id.* at 2022.
[184] *Id.* at 2016.
[185] *Id.* at 2021.
[186] *Id.* at 2023.
[187] *Id.* at 2016.
[188] *Id.*
[189] *Id.* at 2023.
[190] *Id.* at 2024.
[191] *Id.* at 2024–26 (quoting Commission's allegation).
[192] *Id.* at 2025.

adviser and the board "ignored or failed to give adequate consideration to a number of the general and specific factors set forth in ASR 118."[193] The judge found, for example, that the valuation failed to take into account the absence of firms interested in acquiring Margaux, the implications of Margaux's delisting, the firm's financial statements, and trading prices.[194] Because these factors were not taken into account, the judge concluded that the holding was not valued based on what the fund "could receive under current, albeit unfavorable, conditions, but according to what the [f]und might receive if the so-called 'true' value were realized upon sale of the entire company or a controlling portion therein."[195]

### *B. The Advisers Act and Valuation*

#### *1. Statutory Framework*

The Advisers Act imposes general antifraud provisions on all investment advisers.[196] For situations involving an adviser's inaccurate valuation of securities, Section 206(2) of the Advisers Act is the most important of the antifraud provisions because scienter is not an element to prove a violation; instead, it establishes a fiduciary duty upon all investment advisers.[197] The Supreme Court articulated the fiduciary duty concept in *SEC v. Capital Gains Research Bureau, Inc.*[198] The Supreme Court drew on the purpose of the federal securities laws "to substitute a philosophy of full

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[193] *Id.*

[194] *Id.*

[195] *Id.* at 2026.

[196] *General Information on the Regulation of Investment Advisers*, U.S. SEC. AND EXCH. COMM'N (Mar. 11, 2011), https://www.sec.gov/divisions/investment/iaregulation/memoia.htm [https://perma.cc/DX48-MAXW].

[197] Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(2) (2012). Notably, the Investment Company Act does not have an equivalent provision. However, Section 36(a) of the Investment Company Act empowers the Commission to seek relief against officers, directors, members of any advisory board, advisers, investment advisers, depositors, or principal underwriters of a registered investment company for "any act or practice constituting a breach of fiduciary duty[.]" 15 U.S.C. § 80a-35(a). In addition, the Investment Company Act has provisions for false filings by a registered investment company under Section 34(b), which would apply to false valuations. 15 U.S.C. § 80a-35(b).

[198] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[199]

Under the Court's interpretation of Section 206(2) in *Capital Gains*, the adviser, as a fiduciary to its client, is obligated to disclose potential conflicts of interest. As the Court explained:

> An investor seeking the advice of a registered investment adviser must, if the legislative purpose is to be served, be permitted to evaluate ... overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving "two masters" or only one "especially ... if one of the masters happens to be economic self-interest."[200]

For violations of Section 206(2), the Commission is not required to show economic harm to investors[201] or that the adviser had scienter to defraud the client.[202] The Commission has utilized Section 206(2) in a variety of enforcement actions.[203] The concept has not been fully developed in enforcement actions involving valuation, although at least one action discussed in more detail in Section I.B.2 alleged a Section 206(2) violation.[204]

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[199] *Id.* at 186 (italics in original).

[200] *Id.* at 196 (citing U.S. v. Mississippi Valley Generating Co., 364 U.S. 520, 549 (1961)).

[201] *See, e.g.*, Vernazza v. SEC, 327 F.3d 851, 859–60 (9th Cir. 2003); SEC v. Slocum, Gordon, & Co., 334 F. Supp. 2d 144, 149 (D.R.I. 2004); *In re* Fundamental Portfolio Advisors, Securities Act Release No. 33-8251, Exchange Act Release No. 34-48; Investment Company Act Release No. 26,099; 80 SEC Docket 1851, 1863 (July 15, 2003) (Commission decision).

[202] Instead, courts have applied a test of simple negligence. *See Capital Gains Research Bureau, Inc.*, 375 U.S. at 195; SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992); SEC v. Bolla, 401 F. Supp. 2d 43, 72 (D.D.C. 2005), *aff'd in part*, SEC v. Washington Inv. Network, 475 F.3d 392 (D.C. Cir. 2007).

[203] *See, e.g.*, *In re* Transamerica Fin. Advisors, Inc., Exchange Act Release No. 71850, Investment Advisers Act Release No. 3808, 108 SEC Docket 2522 at 6 (Apr. 3, 2014) (miscalculation of client fees); *In re* Western Asset Mgmt. Co., Investment Advisers Act Release No. 3763, 108 SEC Docket 673 at 6 (Jan. 27, 2014) (failure to reimburse clients pursuant to internal policies); *In re* Martin Currie Inc., Investment Company Act Release No. 30,062, Investment Adviser Act Release No. 3404, 103 SEC Docket 2336, 2345–46 (May 6, 2012) (discussing an adviser who directed one fund to transact with another fund for the purpose of maintaining liquidity in the second fund); *In re* Palmer, Investment Advisers Act Release No. 2757, 93 SEC Docket 2316, 2318 (July 23, 2008) (unauthorized transfers from two private funds designed to satisfy margin calls on a third fund).

[204] *See infra* note 256 and accompanying text.

Conceptually, an adviser's fiduciary duty extends to its valuation policies. An adviser's valuation presents potential conflicts of interest wherein the adviser may have incentives to reach an attractive valuation to reap higher fees, or otherwise benefit itself, to the detriment of the fund and the fund's investors.[205] For example, an adviser that consistently selects a valuation methodology that is higher than alternative methodologies could expose itself to a Section 206(2) violation if it did not disclose this conflict. To date, the Commission has not taken this approach in enforcement actions, and has instead focused on other factors discussed previously.[206]

The remaining antifraud provisions of the Advisers Act are similar to the antifraud provisions in the Securities Act and Exchange Act.[207] Section 206(1) prohibits advisers from employing "any device, scheme or artifice to defraud any client or prospective client[.]"[208] Scienter is required to show a Section 206(1) violation.[209] Because of the Commission's interpretation of "client" over the years, Section 206(1) is often utilized in situations where the adviser serves clients in separately managed accounts.[210] In contrast,

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[205] At least one author has described valuation issues in the context of conflicts of interest in discussing adviser's valuation policies over private funds. *See* Ryan Sklar, Note, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77 FORDHAM L. REV. 3251, 3267–68 (2009).

[206] See *infra* notes 243–46 and accompanying text in discussing the types of theories the Commission has generally brought.

[207] There are important differences in the basic elements of the Advisers Act and Exchange Act provisions. Section 10(b) and Rule 10b-5 of the Exchange Act, for example, require the fraudulent conduct be "in connection with" a purchase or sale of securities. 15 U.S.C. § 78(b) (2012); 17 C.F.R. § 240.01b-6 (2012). No such requirement is present for Section 206 violations. 15 U.S.C. § 80b-6.

[208] 15 U.S.C. § 80b-6(1).

[209] *See, e.g.*, Vernazza v. SEC, 327 F.3d 851, 859–60 (9th Cir. 2003); SEC v. Steadman, 967 F.2d 636, 641 n.3 (D.C. Cir. 1992); Steadman v. SEC, 603 F.2d 1126, 1134 (5th Cir. 1979) *aff'd on other grounds,* 450 U.S. 91 (1981); SEC v. EagleEye Mgmt., 975 F. Supp. 2d 151, 158 (D. Mass. 2013); SEC v. Treadway, 430 F. Supp. 2d 293, 338 (S.D.N.Y. 2006); SEC v. Bolla, 401 F. Supp. 2d 43, 66 (D.D.C. 2005).

[210] Historically, a pooled investment vehicle was counted as one client rather than counting each investor in the vehicle as an individual client. *See* Goldstein v. SEC, 451 F.3d 873, 880 (D.C. Cir. 2006). After the *Goldstein* decision, there was some doubt whether Sections 206(1) and 206(2) of the Advisers Act applied to fraudulent conduct that harmed investors of pooled investment vehicles. *See, e.g.*, SEC v. Northshore Asset Mgmt. 2008 WL 1968299, at n.3 (S.D.N.Y. 2008). In contrast, the Commodity Futures Trade Commission has

Section 206(4) and related Rule 206(4)-8 specifically address an adviser's fraudulent conduct in pooled investment vehicles.[211] Rule 206(4)-8 prohibits advisers from two general categories of conduct. The rule prohibits advisers from making "any untrue statement of a material fact or to omit to state a material fact ...."[212] It also prohibits advisers from engaging in "any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor[.]"[213] Like Section 206(2), these provisions have been utilized in a variety of contexts, including cases that have a valuation component.[214] However, unlike Section 206(2), these provisions tend to reach more overtly fraudulent conduct because of the scienter element.

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counted clients of commodity trading advisers by individual investor. *See* 7 U.S.C. § 6(m) (2010). Prior to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, advisers could avoid registration when they managed funds on behalf of no more than fifteen clients where clients were interpreted to count a fund as one client. *See* 15 U.S.C. § 80b-3(b)(3) (2010). The legislation repealed this provision.

[211] 17 C.F.R. § 275.206(4)-8 (2015).

[212] 17 C.F.R. § 275.206(4)-8(a)(1).

[213] 17 C.F.R. § 275.206(4)-8(a)(2).

[214] The conduct in many of these cases meets the legal requirements of multiple antifraud provisions, including Section 206(2) of the Advisers Act. *See, e.g.*, *In re* West Coast Asset Mgmt., Securities Act Release No. 33-9501, Investment Advisers Act Release No. 3746, 107 SEC Docket 5599, 5600 (Dec. 23, 2015) (discussing misrepresentations to investor regarding prior redemption activity of a fund triggered Sections 206(2), 206(4) and Rule 206(4)-8 violation in addition to a Securities Act violation); *In re* F-Squared Investments, Inc., Investment Company Act Release No. 31,393, Investment Advisers Act Release No. 3988, 110 SEC Docket 2953 at 10 (Dec. 22, 2014) (misleading back-testing of performance data of adviser's strategy included violations of Sections 206(1), 206(2), 206(4)-8, and Rule 206(4)-8 of the Advisers Act); *In re* Ambassador Cap. Mgmt., Initial Decision Release No. 672, 108 SEC Docket 2637 at 1 (Sept. 19, 2014) (discussing an adviser's misleading statements to board regarding a fund's exposure to mortgage-backed securities violated Sections 206(1) and 206(2), among others); *In re* Chariot Advisors, Exchange Act Release No. 72,541, Investment Company Act Release No. 31,149, Investment Advisers Act Release No. 3872, 108 SEC Docket 930 at 9 (July 3, 2014) (discussing an adviser's misrepresentations to fund board regarding trading strategy violated Sections 206(2), 206(4) and Rule 206(4)-8 of the Advisers Act among others); *In re* Oppenheimer Funds, Securities Act Release No. 33-9329, Exchange Act Release No. 34-67142, Investment Company Act Release No. 30,099, Investment Advisers Act Release No. 3417, 103 SEC Docket 2830, 2834 (June 6, 2012) (Section 206(4) and Rule 206(4)-8 violations among others); *In re* Quantek Asset Mgmt., Securities Act Release No. 33-9326, Investment Company Act Release No. 30,085, Investment Advisers Act

Although the antifraud provisions of the Advisers Act reach all advisers, nearly all of the specific prohibitions and rules-based provisions apply only to registered advisers or advisers required to be registered.[215] The threshold for adviser registration is based primarily on the adviser's assets under management.[216] Once registered, advisers assume certain obligations under the Advisers Act, which extend to their advisory activities over any individual clients, registered investment companies, or private funds under management.[217] Unlike the Investment Company Act, however, these obligations are largely principles based regulations and touch on valuation indirectly.

As a result, the provisions of the Advisers Act focus on disclosure, with a particular emphasis on revealing conflicts of interest. Advisers are obligated to file Form ADV and a related brochure, which are publicly available.[218] Among other things, Form ADV requires the advisor to state its regulatory assets under management,[219]

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Release No. 3408, 103 SEC Docket 2677, 2683 (May 29, 2012) (concerning adviser of private fund misrepresentations of "skin in the game," related party transactions, and investment process triggering Section 206(4) and Rule 206(4)-8 violations among others).

[215] 15 U.S.C. § 80b-3a(a)(2)(B) (2012).

[216] The Advisers Act currently requires advisers to register if they have at least $100 million in assets under management. *See* 15 U.S.C. § 80b-3a(a)(2)(B)(ii)(II). The Advisers Act affords an exception to registration for advisers who manage private funds and have U.S. assets under management of less than $150 million. *See* 15 U.S.C. § 80b-3(m)(1). Advisers below these thresholds must typically register with the states in which they operate. *See* 15 U.S.C. § 80b-3a(a). A variety of advisers with less than $100 million may still register with the Commission if they meet certain criteria. For example, advisers who provide services primarily through the Internet may register with Commission regardless of their assets under management. *See* 17 C.F.R. § 275.203A-2(e).

[217] *Information for Newly-Registered Investment Advisers*, U.S. SEC. AND EXCH. COMM'N (Nov. 23, 2010), https://www.sec.gov/divisions/investment/adv overview.htm [https://perma.cc/5VCH-AEUB].

[218] 15 U.S.C. § 80b-4(a).

[219] *See* U.S. SEC. & EXCH. COMM'N, FORM ADV, UNIFORM APPLICATION FOR INVESTMENT ADVISOR REGISTRATION AND REPORT BY EXEMPT REPORTING ADVISORS, pt. 1A, item 1, at 9–10, http://www.sec.gov/answers/formadv.htm [https://perma.cc/UC39-LJLW] [hereinafter Form ADV]. Regulatory assets under management may vary substantially from an adviser's actual assets under management because the definition excludes netting indebtedness or other accrued but unpaid liabilities. In addition, if an adviser's portfolio derives less than 50 percent of its value from securities, it is excluded. *See id.* at pt. 1A, instruction 5b, at 7.

asset value in accounts held by the adviser,[220] gross asset value of any private fund;[221] and identify auditors[222] and third parties responsible for valuing any portfolio assets.[223] Populating Form ADV with incorrect information, such as inaccurate regulatory assets under management, constitutes a separate violation from the antifraud provisions[224] and does not require a showing of scienter.[225] More generally, the Advisers Act also has provisions governing a registered adviser's advertising materials, which could touch on valuation to the extent that performance is exaggerated because of inflated asset values.[226] Like misleading statements in the Form ADV, such misstatements constitute a securities violation.[227]

Registered advisers are also required to complete Form PF for private funds the adviser manages if it meets a certain dollar threshold.[228] Form PF requires a more detailed description of the private fund's investments than is required in Form ADV. Many aspects of Form PF require valuation information, such as: identifying the investment style of the fund and the associated regulatory assets under management and net assets under management;[229] a breakdown of the U.S. GAAP valuation hierarchy of the private fund's

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[220] *See id.* at pt. 1A, item 9, at 14.

[221] *See id.* at sched. D, item 11, at 7.

[222] *See id.* at sched. D, item 23, at 9.

[223] *See id.* at sched. D, item 27, at 10. This item requires the adviser to identify the proportion of the assets under management that are valued by third parties. *Id.*

[224] *See* 15 U.S.C. § 80b-7 (2012).

[225] *See, e.g.*, SEC v. K.W. Brown and Co., 555 F. Supp. 2d 1275, 1309 (S.D. Fla. 2007); *In re* Fields, Securities Act Release No. 9727, Exchange Act Release No. 74,344, Investment Company Act Release No. 31,461, Investment Advisers Act Release No. 4028, 2015 WL 728005 at *28 n.101 (Feb. 20, 2015); *In re* Montford and Co., Investment Advisers Act Release No. 3829, 2014 WL 10761140 at *27 (May 2, 2014); *In re* Knelman Asset Mgmt. Group, Investment Company Act Release No. 30,766, Investment Advisers Act Release No. 3705, 107 SEC Docket 2976, 2980 n.4 (Oct. 28, 2013) (settled matter); *In re* Warwick Capital Mgmt., Investment Advisers Act Release No. 2694, 92 SEC Docket 1137, 1144 (Jan. 16, 2008); *In re* Disraeli, 90 SEC Docket 385, 397 (March 5, 2007).

[226] *See* 17 C.F.R. § 275.206(4)-1 (2015).

[227] *See id.*

[228] In order for obligations to file Form PF to be triggered, the adviser must manage at least $150 million in private fund assets. *See* 17 C.F.R. § 275.204(b)-1(a).

[229] *See* U.S. SEC. & EXCH. COMM'N, FORM PF, REPORTING FORM FOR INVESTMENT ADVISERS TO PRIVATE FUNDS AND CERTAIN COMMODITY POOL OPERATORS AND COMMODITY TRADING ADVISORS, § 1a, item B, at 2–3, https://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf [https://perma.cc/7692-F68B].

assets by asset class;[230] and fund performance information.[231] Certain large advisers must provide additional information.[232] Like Form ADV, if an adviser files an inaccurate Form PF, it is subject to liability.[233]

Some Advisers Act provisions touch on portfolio valuation by creating operational obligations. Rule 206(4)-2 requires that advisory clients receive statements on at least a quarterly basis "identifying the amount of funds and of each security in the account at the end of the period[.]"[234] More significantly, the rule mandates that certain advisers retain an accounting firm to conduct surprise examinations or issue financial statements on an annual basis.[235] For example, an adviser managing a pooled investment vehicle must obtain and distribute to investors an audited financial statement or subject itself to an annual surprise examination.[236] These activities require a third party, an accountant, to review the valuation of the securities held in the investment vehicle.[237]

Rule 206(4)-7 is another operational rule that touches on valuation. The rule requires the development of "written policies and procedures reasonably designed to prevent violation" of the Advisers Act.[238] Like the counterpart compliance rule for registered investment companies,[239] the rule does not enumerate specific elements that advisers should implement in their policies and procedures.[240] However, the Commission's adoption release for the rule makes plain that the mandated policies and procedures should address the adviser's "[p]rocesses to value client holdings and

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[230] *See id.* § 1b, item B, at 5–6.

[231] *See id.* § 1b, item C, at 7–8.

[232] These additional disclosures are triggered by certain advisers who have assets under management of $1.5 billion or more. *See id.* ¶ 3, at 2.

[233] *See* 15 U.S.C. § 80b-7 (2012); *see also* 17 C.F.R. § 275.203-1 (requiring most investment adviser applicants to file Form ADV); 17 C.F.R. § 275.204(b)-1 (requiring certain investment advisers to submit Form PF).

[234] 17 C.F.R. § 275.206(4)-2(a)(3).

[235] *See* 17 C.F.R.§ 275.206(4)-2(a)(4).

[236] *See* 17 C.F.R.§ 275.206(4)-2(b)(4).

[237] *See id.*

[238] 17 C.F.R. § 275.206(4)-7(a).

[239] *See* 17 C.F.R. § 270.38a-1(a)(2) (2006) (to the extent an adviser is providing services to a registered investment company, the company's board reviews the adviser's policies and procedures to determine their robustness).

[240] *See* 17 C.F.R. § 275.206(4)-7.

assess fees based on those valuations[.]"[241] One purpose in subjecting advisers to registration and to this compliance regime was to address frauds that involved, among other things, "improper valuation of assets."[242]

*2. Commission Administrative Actions*

The Commission has brought several administrative actions against advisers of private funds for Advisers Act violations. Enforcement cases rely primarily on violations of Section 206. The fact patterns in these cases have varied widely and included situations where the adviser failed to follow the valuation procedures represented to investors;[243] the adviser misrepresented the portfolio despite contradicting authoritative evidence;[244] the adviser's valuations were part of a larger effort to fraudulently inflate asset values;[245] and the adviser's basis for a valuation was no longer

[241] Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, 81 SEC Docket 2775, 2779 (Dec. 17, 2003).

[242] Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333, 84 SEC Docket 1032, 1047 (Dec. 2, 2004).

[243] *See, e.g.*, *In re* Retirement Inv. Advisors, Inc., Exchange Act Release No. 76,218, Investment Advisers Act Release No. 4237, 2015 WL 6352065 at *2 (Oct. 21, 2015) (settled matter); *In re* Lynn Tilton, Investment Company Act Release No. 31,539, Investment Advisers Act Release No. 4053, Accounting and Auditing Enforcement Release No. 3644, 2015 WL 1407564 at *2 (Mar. 30, 2015) (proceeding ongoing); *In re* Oppenheimer Asset Mgmt., Inc., Securities Act Release No. 33-9390, Investment Advisers Act Release No. IA-3566, 105 SEC Docket 3387, 3387–88 (Mar. 11, 2013) (settled matter).

[244] *See In re* Leaddog Cap. Markets, LLC, Release No. 468, 104 SEC Docket 2604, 2608 (Sept. 14, 2012), *aff'd*, Release No. 68,205, 104 SEC Docket 3996, 3996 (Nov. 9, 2012). In *Leaddog*, the adviser of a private fund distributed a due diligence questionnaire to a potential investor falsely claiming that the fund held approximately 50 percent of its assets in illiquid investments. However, the fund's audited financial statements disclosed that the fund held a much higher percentage—92 percent—of fund assets as illiquid. *Id.* at 2608.

[245] *See, e.g.*, *In re* Kuperman, Securities Act Release No. 10,009, Exchange Act Release No. 76,991, Investment Advisers Act Release No. 4323, Investment Company Act Release No. 31,973, 2016 WL 336086 at 3–4 (Jan. 28, 2016), https://www.sec.gov/litigation/admin/2016/33-10009.pdf [https://perma.cc/KSF2-YCMB], (settled matter) (regarding an adviser overvaluation of an illiquid penny stock holding that comprised over 20 percent of the portfolio); *In re* Alphabridge Cap. Mgmt., LLC, Investment Advisers Act Release No. 4135, Investment Company Act Release No. 31,700, 2015 WL 3982040 at 2 (July 1, 2015), https://www

valid.[246] This last category of administrative cases—the adviser's basis for valuation—represent more unusual examples of scrutinizing an adviser's valuation methodology.

The *Oppenheimer* settled matter provides a good illustration of an adviser that allegedly failed to follow its valuation procedures.[247] The adviser managed a private fund that invested in other funds—a fund of funds.[248] The pitch book describing the fund of funds disclosed that its assets were valued based on the prices provided by the underlying managers of the funds.[249] The portfolio manager, however, elected to discard the stated value of one underlying fund and instead used a higher valuation.[250] The deviation in values

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.sec.gov/litigation/admin/2015/ia-4135.pdf [https://perma.cc/NYF4-L65T] (settled matter) (involving a scheme to use manipulated broker quotes to prop up securities valuation); *In re* John Thomas Cap. Mgmt. Grp. LLC, Initial Decision Release No. 693, 2014 WL 5304908 at 19, (Oct. 17, 2014), https://www.sec.gov/alj/aljdec/2014/id693cff.pdf [https://perma.cc/DW78-M98J], *enforcing*, Securities Act Release No. 9396, 105 SEC Docket 4051, 4053–54 (Mar. 22, 2013) (partially settled matter, litigation ongoing) (involving an adviser who used several manipulative devices, including a stock touter to manipulate the value of portfolio stocks upward, and inconsistent valuations of the same securities across funds); *In re* Oxford Inv. Partners, LLC, Investment Advisers Act Release No. 3553, 105 SEC Docket 2870, 2870, 2871 (Feb. 15, 2013) (settled matter) (involving valuation derived from baseless projections of the adviser's business in an effort to sell a stake in the adviser); *In re* Koch, Release No. 707, 103 SEC Docket 3339, 3340 (June 15, 2012), *modifying*, Release No. 458, 103 SEC Docket 2664, 2664 (May 24, 2012) (regarding an effort to mark the close, and also inflated, net asset values of clients).

[246] *See, e.g.*, *In re* Bunzel, Exchange Act of 1934 Release No. 67,140, Investment Advisers Act of 1940 Release No. 3416, Investment Company Act of 1940 Release No. 30,098, 103 SEC Docket 2941, 2942–43 (June 6, 2012) (settled matter); *In re* Cornerstone Cap. Mgmt., Inc., Investment Advisers Act of 1940 Release No. 2855, 95 SEC Docket 1379, 1380 (Mar. 20, 2009) (settled matter); *In re* Springer Inv. Mgmt., Inc., Investment Advisers Act Release No. 2434, 86 SEC Docket 803, 805 (Sept. 21, 2005) (settled matter). In one recent settled matter, a third party administrator played a role in inappropriately valuing private funds by failing to address recurring loans made by the adviser that remained unpaid. *See In re* Apex Fund Servs. (US), Inc., Investment Advisers Act Release No. 4429, 2016 WL 3345650 (June 16, 2016), https://www.sec.gov/litigation/admin/2016/ia-4429.pdf [https://perma.cc/W4T2-G9BZ]. The settlement charged the administrator with causing the adviser's violation of Sections 206(2) and 206(4) of the Advisers Act. *Id.*

[247] *See In re Oppenheimer Asset Mgmt., Inc.*, 105 SEC Docket at 3389.

[248] *Id.* at 3387.

[249] *Id.* at 3388.

[250] *Id.* at 3389.

caused "a material increase in the value ... and ... performance" of the fund of funds.[251]

While the portfolio manager's work group modified the performance table in the pitch book, they failed to revise the valuation disclosure or to submit the revised pitch book to the adviser's compliance department.[252] According to the administrative order, "[d]uring their marketing efforts, the [p]ortfolio [m]anager and others in his group touted the performance of [the underlying fund and the fund of funds] to prospective investors[.]"[253] The employees made other misrepresentations concerning the investment as well, such as making claims that the underlying fund was audited and the increased value was a reflection of the underlying fund's performance.[254] In addition to violations of Section 206(4) and related Rule 206(4)-(8) of the Advisers Act, the parties agreed to settle on charges of deficient policies and procedures and the antifraud provisions of the Securities Act.[255]

The *Cornerstone Capital* settled matter explored a situation where the adviser allegedly refused to make downward adjustments of portfolio security valuations, despite being confronted with adverse information that strongly suggested the securities were impaired.[256] The adviser managed client funds in separately managed accounts.[257] The settled order did not discuss the adviser's valuation methodology on the accounts, focusing instead on the headings in quarterly client statements that listed the "market price" and "total market value" of the various investments the client held.[258] The Commission Order suggests that the adviser's selection of investments was poor since many were ultimately fraudulent.[259] For example, the adviser invested client funds in a currency exchange program that later was raided by Costa Rican authorities.[260] The authorities seized assets and froze bank accounts, arrested one of the program's promoters, and charged

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[251] *Id.*
[252] *Id.*
[253] *Id.*
[254] *Id.* at 3390.
[255] *Id.*
[256] *In re* Cornerstone Cap. Mgmt., Inc., Investment Advisers Act Release No. 2855, 95 SEC Docket 1379, 1380 (Mar. 20, 2009).
[257] *Id.*
[258] *Id.* at 1381.
[259] *See id.* at 1380.
[260] *Id.* at 1381.

him with fraud.[261] The adviser was aware of the arrest and charges.[262] In addition, the adviser read news reports, including an article from *The Wall Street Journal* describing the program "as a classic Ponzi scheme," and learned that the program ceased operations and ceased paying interest payments.[263] Despite knowing these issues, the adviser continued to send clients quarterly statements that showed the value of the investment in the program at cost plus accrued interest.[264] Based on this example and other similar scenarios, the parties settled to Section 206(1) and 206(2) Advisers Act charges.[265]

In contrast to *Cornerstone Capital*, the *Bunzel* settled matter addressed the adviser's valuation methodology in two commonly managed private funds that were structured as partnerships.[266] In *Bunzel*, the adviser, who was the general partner of both funds, could set a value that he "may reasonably determine in good faith."[267] The Order focused on the adviser's reasonableness in setting a valuation and did not explore whether the adviser was acting in good faith.[268] In other words, the alleged violation came about because of the unreasonableness of the valuation in light of the factors that the adviser used to justify it.[269]

The funds' largest investment was in a privately held registered investment adviser that was first acquired in the 1990s.[270] Over time, the adviser adjusted the value of this investment upward based on the price at which the firm bought or sold its shares in private transactions.[271] In 2008, these adjustments grew dramatically; the adviser raised the value of the holding by 88 percent as of

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[261] *Id.*
[262] *Id.*
[263] *Id.*
[264] *Id.*
[265] *Id.* at 1379–80, 1383.
[266] *See, e.g.*, *In re* Bunzel, Securities Exchange Act of 1934 Release No. 67,140, Investment Advisers Act of 1940 Release No. 3416, Investment Company Act of 1940 Release No. 30,098, 103 SEC Docket 2941, 2942–43 (June 6, 2012) (settled matter).
[267] *Id.*
[268] *Id.*
[269] *Id.* at 2943.
[270] *Id.* at 2942.
[271] *Id.*

August 2008.[272] With this higher value, the holding comprised 76 percent of the total portfolio.[273] The adviser relied on four reasons for the increased valuation: (1) the portfolio firm had preliminary discussions to repurchase shares for approximately the valuation price; (2) the portfolio company's assets under management grew substantially during 2008; (3) the portfolio company's revenues were increasing substantially; and (4) the adviser attempted to make comparisons to other large publicly traded companies in the financial sector.[274]

However, by December 2008, all of these factors changed dramatically, and the Commission alleged "there was no *reasonable* basis to support [the adviser's] valuation" because the adviser's reasons that supported the valuation "no longer existed."[275] The Order observes that the portfolio firm's discussion to repurchase shares had "ceased" by October 2008 and that its assets under management and revenues decreased substantially from earlier periods.[276] Further, "financial markets became extremely volatile—especially financial sector stocks."[277] Despite these adverse events, the adviser failed to reduce its valuation of the investment until 2010 when two valuation firms suggested the value of the funds' holdings in the firm were significantly lower.[278] The parties settled to charges of violations of Section 206(4) and Rule 206(4)-(8) of the Advisers Act.[279]

## II. The Court Cases and the Antifraud Statutes

### *A. General Court Views on Valuations in Private Actions*

Advisory clients and investors seeking redress from advisers typically rely on the antifraud provisions of the Securities Act and

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[272] *Id.*
[273] *Id.* at 2942–43.
[274] *Id.* at 2943.
[275] *Id.* (emphasis added).
[276] *Id.*
[277] *Id.*
[278] *Id.*
[279] *Bunzel* also involved other conduct not related to valuations. In particular, the order also discussed the adviser's failure to obtain audited financial statements and obtaining management fees in excess of those disclosed to the funds' investors. *See id.* at 2943–44.

Exchange Act.[280] Although the precise elements of these provisions vary, they are similar and somewhat analogous to the Section 206 provisions in the Advisers Act.[281] The core theory of liability for the Securities Exchange Act provisions is that an adviser's inaccurate portfolio valuations may become material misstatements of fact.[282] Beside the typical hurdles in bringing a claim under Section 17(a), Section 10(b) and Rule 10b-5,[283] courts have been reluctant to entertain claims based on valuation.[284]

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[280] Private plaintiffs are largely foreclosed from relying on provisions of the Investment Company Act and Advisers Act to bring a claim; however, private litigants may allege various common law claims related to such situations. *See, e.g.*, Investment Company Act of 1940, 15 U.S.C. § 80a-35 (2012). However, such a theory would likely be difficult to prevail except in egregious cases. *See, e.g.*, Abu Dhabi Com. Bank v. Morgan Stanley & Co., 888 F. Supp. 2d 431, 440, 442, 444 (S.D.N.Y. 2012) (discussing a suit grounded in New York common law alleging, among other things, fraudulent credit ratings that inflated the value of certain mortgage-backed securities). Another indirect potential avenue for private investors who participated in registered investment companies—which may also be difficult—is to argue the adviser's fee, as a result of valuation issues, was excessive. *See, e.g.*, Jones v. Harris Associates, 559 U.S. 335, 346 (2010) (finding adviser's fees must be "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining."); *see also* Sivolella v. AXA Equitable Life Ins. Co., Slip Op., 2016 WL 4487857 (Aug. 25, 2016).

[281] *See* 15 U.S.C. § 80b-6a.

[282] *See* 15 U.S.C. § 78r.

[283] The antifraud provisions have a number of requirements that are necessary to satisfy a claim and to prevail successfully. These provisions require that any alleged misstatements or omissions of facts be material; therefore, courts have defined material facts as information for which there is a substantial likelihood that a reasonable investor would consider in making an investment decision. *See, e.g.*, Basic Inc. v. Levinson, 485 U.S. 224, 231–32, 238 (1988) (citing SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 862 (2d Cir. 1968)). For most provisions, courts also require the perpetrators of the fraud to have scienter—"a mental state embracing intent to deceive, manipulate, or defraud." Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194 (1976). More recently, the Supreme Court has also placed additional requirements on who may be liable for making such statements. *See* Janus Cap. Grp., Inc. v. First Derivative Traders, 564 U.S. 135, 144 (2011).

[284] Private litigants also face additional judicial scrutiny because of the Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(1) (2012) (requiring securities fraud complaints to specify each misleading statement and set forth the facts on which a belief that a statement is misleading was formed). *See, e.g.*, Pa. Pub. Sch. Emps.' Ret. Sys. v. Bank of Am., 974 F. Supp. 2d 341, 351 (S.D.N.Y. 2012).

Courts' reluctance in accepting plaintiff theories related to misvaluation of portfolio assets is grounded in views regarding statements of value for purposes of the antifraud statutes. In analyzing statements for potential liability under Section 10(b) and Rule 10b-5, courts have divided statements into two categories: statements of fact and statements of opinion.[285] The seminal case in this area is *Virginia Bankshares, Inc. v. Sandberg*.[286] In *Virginia Bankshares*, a company's board of directors provided its reasoning for voting for a forced buyout of minority shareholders by disclosing that the board thought the buyout price was attractive in a proxy statement.[287] The plaintiff, a minority shareholder, filed an action alleging violations of Section 14(a) of the Exchange Act related to misstatements in proxy solicitations.[288] The plaintiff contended that the statement concerning the attractiveness of the buyout price was untrue because it was not an attractive offer and the board voted in favor of the resolution under pressure from the majority shareholder.[289] The Supreme Court in *Virginia Bankshares* faced somewhat of a conundrum because the inquiry for a statement of fact under Section 14(a)—as well as other antifraud provisions—was whether the statement was untrue.[290] However, the board in *Virginia Bankshares* was expressing an opinion.[291] The Court acknowledged that opinion statements can be misleading, but cabined the scope of review:

> Attacks on the truth of directors' statements of reasons or belief, however, need carry no such threats. Such statements are factual in two senses: as statements that the directors do act for the reasons given or hold the belief stated and as statements about the subject matter of the reason or belief expressed .... Reasons for directors' recommendations or statements of belief are ... characteristically matters of corporate record subject to documentation, to be supported or attacked by evidence of historical fact outside a plaintiff's control. Such evidence would include not only corporate minutes and other statements of the directors themselves, but circumstantial evidence bearing on the facts that would reasonably underlie the reasons claimed and the honesty of any statement that

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[285] Va. Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1092 (1991).
[286] *See generally id.*
[287] *Id.* at 1084.
[288] *Id.*
[289] *Id.* at 1088–89.
[290] *Id.* at 1086–87.
[291] *Id.* at 1098.

> those reasons are the basis for a recommendation or other action, a point that becomes especially clear when the reasons or beliefs go to valuation in dollars and cents.[292]

With *Virginia Bankshares* as a guide, subsequent courts have evaluated the contours of statements concerning valuations to delineate pure opinions from quantifiable and verifiable facts. In some cases, courts conclude that the only area of liability in a statement is whether the speaker of the statement did not believe the opinion uttered because the statement was ultimately subjective.[293] For example, a number of cases have been brought by disgruntled investors against public companies who allegedly misvalued mortgage-backed securities.[294] The general fact pattern of these cases is that the company held the asset on its balance sheet and failed to mark down the value in a timely fashion as market conditions for the security became adverse.[295] The courts emphasized that the securities were complex and reliant on pricing models, which required some element of judgment.[296]

Courts have been unreceptive of other fraud claims in situations similar to an adviser's efforts to fair-value securities in a fund. For example, one strand of cases treating valuation as entirely subjective and immune to most claims of fraud relates to situations where applicable accounting guidance provides wide latitude to the party valuing the security.[297] Further, in these situations, courts have

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[292] *Id.* at 1092–93.

[293] *See, e.g.*, Fait v. Regions Fin. Corp., 655 F.3d 105, 111 (2d Cir. 2011).

[294] Fulton Cty. Emps. Ret. Sys. v. MGIC Inv., 675 F.3d 1047, 1048 (7th Cir. 2012).

[295] *See Fait*, 655 F.3d at 108; *In re* Barclays Bank PLC Sec. Litig., No. 09 Civ. 1989 (PAC), 2011 WL 31548, at *3–4 (S.D.N.Y. Jan. 5, 2011).

[296] *See, e.g.*, *Fait*, 655 F.3d at 110–11 (plaintiff could not provide an objective standard for the price of the securities); *Fulton Cty.*, 2010 WL 5095294, at *5, 10, 12 (The valuation required "technical concepts" and "there was no single value that could have been applied ... and deemed the 'true value' of the securities.").

[297] *See, e.g.*, MHC Mut. Conversion Fund, L.P. v. Sandler O'Neill & Partners, L.P. 761 F.3d 1121 (10th Cir. 2014) (Plaintiff's allegation that issuer falsely claimed that mortgage portfolio would not be further impaired under GAAP based on internal analysis and input from independent experts rejected because it was an opinion); *see also* Omaha Civilian Emps.' Ret. Sys. v. CBS Corp., 679 F.3d 64, 69 (2d Cir. 2012) (Plaintiff's allegations that goodwill review involving valuation of certain assets should have been done earlier, at most, reflected "failure to comply with Generally Accepted Accounting Principles [("GAAP")], rather than their commission of securities fraud[.]"); *Fait*, 655 F.3d at 110–11 (calculations of goodwill depend on management's judgment); Pa. Pub. Sys. Emps.' Ret. v. Bank of Am., 874 F. Supp. 2d 341, 351 (S.D.N.Y. 2012); *In re* Lehman Bros. Sec. & ERISA Litig., 799 F. Supp. 2d 258, 312 (S.D.N.Y. 2011)

ruled that it is not enough for plaintiffs to show a variance in their approach to how a security should be valued—the plaintiff must also show the dollar impact of the variance.[298] Other cases emphasize the speculative nature of valuations of certain securities, especially where there is no historical data to establish a value.[299] In these cases, generalized disclaimers in a prospectus are sufficient warnings to investors regarding subsequent adverse events.[300]

An interesting application of court views on valuation is *In re Salomon Analyst Level 3 Litigation*.[301] In that case, plaintiffs alleged that an analyst's valuations were overly optimistic.[302] The plaintiffs argued the analyst had an inherent conflict of interest in writing his reports since his employer was an underwriter to the same issuers.[303] The plaintiffs found emails where the analyst doubted the veracity of his own reports.[304] For reports written after the emails, the court found that plaintiffs could allege a violation of Section 10(b) and Rule 10b-5.[305] However, for reports issued prior to the emails, the court foreclosed liability.[306] The court's reasoning turned on a number of factors, including disclosure that the research reports were speculative and that the analyses were marked by a "very low predictability of fundamentals and a high

(discussing relevant accounting guidance permitting varying approaches to value an asset that is left to management's judgment).

[298] *See, e.g.*, Tsereteli v. Res. Asset Securitization Tr., 692 F. Supp. 2d 387, 393 (S.D.N.Y. 2010) (discussing valuations that are not in conformity with standard valuation guidelines are not actionable without more quantification of the impact); *Fulton Cty.*, 2010 WL 5095294, at *8 (discussing plaintiff failing to show impact of the valuation flaws identified and whether it is comparable to the actual write-off the issuer took).

[299] *See, e.g.*, N.J. Carpenters Vacation Fund v. Royal Bank of Scot. Grp., 720 F. Supp. 2d 254, 271 (S.D.N.Y. 2010) (offering materials disclosed risks because of lack of historical data); *Barclays*, 2011 WL 31548, at *8 (offering materials disclosing risks).

[300] *Supra* note 299 and accompanying text.

[301] *See generally In re* Salomon Analyst Level 3 Litig., 350 F. Supp. 2d 477 (S.D.N.Y. 2004).

[302] *Id.* at 482, 492. The view that stock analysts may be conflicted or provide poor advice is not a new one. In Benjamin Graham's seminal work, *The Intelligent Investor*, he notes that "many of them are compelled to analyze with one eye on the stock ticker—a pose not conducive to sound thinking or worthwhile conclusions." BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR, 264–65 (revised ed. 2006).

[303] *Salomon*, 350 F. Supp. 2d at 483.

[304] *Id.* at 485.

[305] *Id.* at 493.

[306] *Id.* at 492.

degree of volatility, suitable only for investors/traders ... that can withstand material losses."[307]

The court described the reports as "detailed, transparent, and primarily based on the companies' own public statements, such as press releases, financial statements, and analyst calls."[308] The court implicitly suggested that this transparency permits investors to draw their own conclusions or compare the reports to other market information. The court observed that the plaintiffs failed to show that the valuation models in the reports were "false or objectively unreasonable[.]"[309]

The *Salomon* plaintiffs also argued that other valuation models at the analyst's firm assigned substantially lower valuations than the analyst's own work that was addressed in a subsequent court decision.[310] The court rejected the argument:

> In contrast to ... objective statements, financial valuation models depend so heavily on the discretionary choices of the modeler ... choice of assumptions ... and choice of "comparables" that the resulting models and their predictions can only fairly be characterized as subjective opinions. Like other opinions, some valuation models may be more or less reliable than other models, have more or less predictive power, or hew more or less closely to conventional wisdom on a subject, but they are nonetheless opinions and not objective facts. An analyst who sets out his own opinion of a stock's value based on the valuation model he finds most persuasive for that company does not omit a material fact by failing to note that others might have different opinions[.] [311]

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[307] *Id.* at 490–91.

[308] *Id.* at 491; *see also* Omaha Civilian Emps.' Ret. Sys. v. CBS Corp., 679 F.3d 64, 69 (2d Cir. 2012) (noting that the red flags identified by plaintiffs were public, concluding therefore that the defendant's "[stock] price would at all pertinent times have reflected the need for, if any, or culpable failure to undertake, if any, interim impairment testing.").

[309] *Salomon*, 350 F. Supp. 2d at 491.

[310] *See In re* Salomon Analyst Level 3 Litig., 373 F. Supp. 2d 248, 351–52 (S.D.N.Y. 2005).

[311] *Id.* at 251–52. The recent Supreme Court decision, *Janus Capital Group v. First Derivative Traders,* may foreclose this type of suit in the future. *See* Janus Cap. Grp. v. First Derivative Traders, 564 U.S. 135, 140–43 (2011). The Court has read into *Janus* the requirement that the maker of a fraudulent statement be authorized to speak on behalf of the entity that the investor relied. *Id.* For a critique of the approach the Court took, see William A. Birdthistle, *The Supreme Court's Theory of the Fund,* 37 J. CORP. L. 771, 775–85 (2012).

Although not involving valuation issues, the recent Supreme Court decision in *Omnicare, Inc. v. Laborers' District Council Construction Industry Pension Fund* illustrates that liability for misrepresentations in fraud cases extends beyond whether the speaker did not believe a stated opinion.[312] In *Omnicare*, the Supreme Court provided hypothetical situations of an issuer's opinion of its compliance that could rise to the level of fraud under the securities laws:

> Consider an unadorned statement of opinion about legal compliance: "We believe our conduct is lawful." If the issuer makes that statement without having consulted a lawyer, it could be misleadingly incomplete. In the context of the securities market, an investor, though recognizing that legal opinions can prove wrong in the end, still likely expects such an assertion to rest on some meaningful legal inquiry .... Similarly, if the issuer made the statement in the face of its lawyers' contrary advice, or with knowledge that the Federal Government was taking the opposite view, the investor again has cause to complain: He expects not just that the issuer believes the opinion (however irrationally), but that it fairly aligns with the information in the issuer's possession at the time.[313]

Because the alleged misstatements in *Omnicare* were made in a registration statement, the Court focused on the context of an opinion in such a document, noting "[i]nvestors do not ... expect opinions contained in those statements to reflect baseless, off-the-cuff judgments, of the kind that an individual might communicate in daily life."[314] Similarly, investors expect an adviser's pronouncement on the value of an investment to be much more than an off-the-cuff judgment.

Some cases decided prior to *Omnicare* have followed this approach. In *Allstate*, the court recognized three possible areas of liability for opinion statements involving "expectations, beliefs, or

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[312] *See* Omnicare, Inc. v. Laborers' Dist. Council Const. Indus. Pension Fund, 135 S. Ct. 1318, 1323–24 (2015). The alleged misrepresentations in *Omnicare* did not involve an investment adviser or the valuation of an asset. The plaintiff made allegations concerning an issuer's registration statement, claiming that its business complied with federal laws. Subsequent events proved the issuer's statements were false and the plaintiff, who had purchased securities in the offering, sued under Section 11 of the Securities Act. *Id.* at 1324.

[313] *Id.* at 1328–29 (footnotes omitted).

[314] *Id.* at 1330.

projections[.]"[315] In addition to situations where the party does not believe the opinion, liability could attach where "there was no reasonable basis for the belief" or if "the speaker is aware of undisclosed facts tending seriously to undermine the statement's accuracy."[316] These cases turn on whether red flags exist that the person making the valuation has awareness. For example, a district court decision in the Second Circuit addressed a claim asserting that certain mortgage-backed securities were overvalued and mark downs delayed.[317] The court explained that because "valuations ordinarily involve questions of business judgment, courts generally decline to find securities fraud stemming from statements about valuations."[318] Although, when "parties maintain high valuations on [securities] in the face of red flags that the valuations are inaccurate, courts have sustained securities fraud claims."[319] The court granted the defendants' motion to dismiss the plaintiffs' claim, it did so on other grounds—that plaintiff failed to plead loss causation adequately.[320] Another court, dealing with a fact pattern involving an investment adviser, rejected the view that valuations are opinions when they are alleged to be part of a larger fraudulent scheme:

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[315] Allstate Life Ins. Co. v. Robert W. Baird & Co., 765 F. Supp. 2d 1113, 1132 (D. Ariz. 2010).

[316] *Id.* (citing Kaplan v. Rose, 49 F.3d 1363, 1375 (9th Cir. 1994)); *see also* MHC Mut. Conversion Fund, L.P. v. Sandler O'Neill & Partners, L.P., 761 F.3d 1109, 1115–16 ("At common law today it is sometimes possible to pursue misrepresentation claims against fiduciaries and those who hold themselves out as experts when they offer opinions that lack an objectively reasonable basis .... [S]ome wonder whether this approach is consistent with the Supreme Court's teachings. As the defendants note, *Virginia Bankshares* seemed to endorse the subjective disbelief/objective falsity test[.]"). Notably, the Tenth Circuit decided *MHC* prior to the Supreme Court's decision in *Omnicare*.

[317] *See* Stratte-McClure v. Morgan Stanley, 784 F. Supp. 2d 373, 376, 391 (S.D.N.Y. 2011).

[318] *Id.* at 387.

[319] *Id.*; *see also* Gosselin v. First Tr. Advisors L.P., No. 08 C 5213, 2009 WL 5064295, at *5 (N.D. Ill. Dec. 17, 2009); *In re* Flag Telecom Holdings Ltd. Sec. Litig., 352 F. Supp. 2d 429, 453–54, 469 (S.D.N.Y. 2005); *In re* Van Wagoner Funds, Inc. Sec. Litig., 382 F. Supp. 2d 1173, 1190 (N.D. Cal. 2004).

[320] *Stratte-McClure*, 784 F. Supp. 2d at 390–91. Private plaintiffs alleging violations under § 10(b) and Rule 10b-5 of the Exchange Act must prove loss causation—the "causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." Emergent Cap. Inv. Mgmt., LLC v. Stonepath Grp., Inc., 343 F.3d 189, 197 (2d Cir. 2013).

> Defendants argue that Plaintiffs have failed to allege facts that support an inference that Defendants' valuation assessments were a part of a fraudulent scheme. Defendants argue that valuation cannot be the basis of a fraud claim because the valuation is "an exercise in discretionary business judgment involving consideration of a variety of factors." However, Plaintiffs are not merely contending Defendants did a poor job in making the valuation assessments. Plaintiffs also contend that Defendants purposefully did the valuation assessments so as to conceal Defendants' misconduct and increase fees.[321]

Cases exploring red flags often look to a number of objective factors underlying the issuer of the securities. For example, in *Van Wagoner Funds*, the court's focus was on various events that impaired the value of a mutual fund's holding of issuer's restricted stock.[322] The *Van Wagoner* plaintiffs sued the fund's auditor, who accepted the fund's valuation of the securities at cost.[323] According to the plaintiffs' theory, the auditor was aware of a number of negative events that affected the value of the issuer's securities, including a withdrawn public offering, the issuer's bankruptcy, change of business plans, announcement of layoffs, and generally worsening business conditions.[324] However, the court ultimately rejected the plaintiffs' claims because "valuation policies were public, as well as all adverse information about the restricted securities in which Van Wagoner Funds had invested, the [investors] have not alleged that [the auditor] concealed any facts from its investors."[325] In *Flag Telecom Holdings*, plaintiffs alleged that a publicly traded company overvalued its trans-Atlantic fiber-optic cable until the company entered bankruptcy and the prior management left.[326] Plaintiffs contended that Flag was in a position to mark down the value of the asset well before the bankruptcy because: (a) prices

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[321] *Gosselin*, 2009 WL 5064295, at *5 (citations omitted).

[322] *In re Van Wagoner*, 382 F. Supp. 2d at 1181. The Commission also brought an enforcement matter against the adviser, which is discussed in note 92.

[323] *In re Van Wagoner*, 382 F. Supp. 2d at 1181.

[324] *Id.*

[325] *Id.* at 1182. Courts have applied similar logic in other valuation contexts. *See, e.g.*, Omaha Civilian Emps.' Ret. Sys. v. CBS Corp., 679 F.3d 64, 69 (2d Cir. 2012); *In re* Salomon Analyst Level 3 Litig., 350 F. Supp. 2d 477, 491 (S.D.N.Y. 2004).

[326] *In re* Flag Telecom Holdings Ltd. Sec. Litig., 352 F. Supp. 2d 429, 436, 439, 442–43 (S.D.N.Y. 2005).

for usage on the cable declined by 70 percent annually from 1999–2001; (b) the company consistently missed sales targets on the route by 80–90 percent; (c) an executive commented that demand had "imploded"; and (d) the company utilized "improper reciprocal transactions" to prop up the value of the cable.[327] The *Flag* plaintiffs' relevant allegations withstood a motion to dismiss for failure to state a claim.[328]

While not specifically addressing valuations, courts have also explored the issue of when projections, which often form a basis of fair value estimates, can be actionable.[329] One key consideration is whether the assumptions in a projection are completely inaccurate. For example, the *Allstate* case involved a municipal bond issuance to fund the construction of an event facility.[330] Payment of the bonds was to be funded in part from the revenue stream the facility would generate.[331] Projections in the official statements showed that the revenue streams were sufficient to meet bond obligations.[332] However, the projections were based on surveys of communities that were four times the size of the metropolitan area where the facility was being built.[333] The defendants commissioned, "or were at least aware of," two other studies—which were not disseminated to investors—which surveyed communities more similar in size to the facility's area and showed a lower revenue

[327] *Id.* at 465.

[328] *Id.* at 469.

[329] There are also specific securities rules and regulations governing projections outside the context of investment advisers that are similar to case law and the *Omnicare* approach. For example, Rule 3b-6 of the Exchange Act and Rule 175 of the Securities Act provide a safe harbor for issuers providing projections in certain filings "unless it is shown that such statement was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." 17 C.F.R. § 240.3b-6(a) (2015); 17 C.F.R. § 230.175(a) (2014). Item 10(b)(1) of Regulation S-K, which discusses projections in issuer filings, requires management to have "a reasonable basis" for the projection. 17 C.F.R. § 229.10(b)(1) (2014). Some provisions may go beyond the case law. For example, Item 10(b)(3) also recommends that if projections are included in a filing, "the disclosures accompanying the projections should facilitate investor understanding of the basis for and limitations of projections." 17 C.F.R. § 229.10(b)(3) (2014).

[330] Allstate Life Ins. Co. v. Robert W. Baird & Co., 756 F. Supp. 2d 1113, 1122 (D. Ariz. 2010).

[331] *Id.* at 1123.

[332] *Id.* at 1124.

[333] *Id.* at 1125.

stream.[334] The *Allstate* court reasoned that since the projections were based on "objectively verifiable demographic data, a fact-finder could conclude with *reasonable* certainty that the [facility] would be unable to generate" the events and attendees projected in the offering statements.[335]

*B. Commission Litigation Involving Valuation Issues*

The Commission cases in federal courts involving valuation issues generally involve scenarios where the investment adviser's conduct is more akin to furthering a fraudulent enterprise.[336] The Commission, like private plaintiffs, faces high hurdles in litigation involving the antifraud provisions.[337] As a result, Commission actions tend to focus on fairly egregious conduct. For example, in *SEC v. Lauer*, the primary defendant orchestrated a manipulation of stock prices in order to inflate the value of private funds he managed.[338] Among his fraudulent actions, Lauer purchased large

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[334] *Id.* at 1124–25.

[335] *Id.* at 1133 (emphasis added).

[336] More recently, the Commission has generally moved toward bringing enforcement actions through administrative proceedings rather than federal courts. For an interesting view of the phenomenon, see Susan D. Resley, *Dealing With The SEC's Administrative Proceeding Trends*, LAW360 (Jan. 13, 2015), http://www.law360.com/articles/610688/dealing-with-the-sec-s-administrative-proceeding-trend [https://perma.cc/YGE8-TDNH]. However, some administrative respondents have begun challenging the growing use of administrative proceedings on constitutional grounds. *See, e.g.*, Hill v. SEC, 114 F. Supp. 3d 1297, 1304–05 (N.D. Ga. 2015). Litigation in this area is ongoing although challengers have faced recent setbacks in their claims. *See, e.g.*, Tilton v. SEC, 824 F.3d 276, 285–86 (2d Cir. 2016). The Commission has rejected constitutional challenges and the D.C. Circuit has upheld the Commission's decision in one matter. *See, e.g.*, *In re* Raymond J. Lucia Cos., Exchange Act Release No. 75837, Investment Advisers Act Release No. 4190, Investment Company Act Release No. 31,806 (Sept. 3, 2015), 2015 WL 5172953, *aff'd* Raymond J. Lucia Cos., Inc. v. SEC, Slip Op., 2016 WL 4191191 (DC Cir., Aug. 9, 2016). In addition, the Commission has amended its rules of practice. *See* Amendments to the Commission's Rules of Practice, Exchange Act Release No. 34-78319 (July 13, 2016), https://www.sec.gov/rules/final/2016/34-78319.pdf [https://perma.cc/2A82-NB7Y].

[337] *See supra* note 280 for a discussion on this issue.

[338] SEC v. Lauer, No. 03-80612-CIV, 2008 WL 4372896, at *12–13 (S.D. Fla. Sept. 24, 2008). Another example of egregious conduct that settled is *SEC v. ICP Asset Management, LLC*, which involved an adviser who sold CDOs in a manner that made certain clients overpay for them, accruing excessive fees to the advisory firm, and shielding other clients from losses. *See* ICP Asset Management, LLC, Litigation Release No. 22477, 104 SEC Docket 1, 2012 WL 3986214

amounts of the stock of shell companies with no operations, driving the price of the shares upward.[339] In one acquisition of $750,000, he claimed the investment's value at $70 million.[340] Without these transactions, the value of the private funds Lauer managed "would have plunged."[341] The Court concluded that the manipulation allowed Lauer "to obtain illegally tens of million[s] of dollars in fees by materially overstating" the valuation.[342]

The primary defendant in *Lauer* had at least two potential justifications for these valuations. The private funds' manager had the "discretion to value securities as ... reasonably determined when they believed that the security did not represent its market value."[343] The private funds' board had no input in the process.[344] In addition, Lauer retained a third party to provide valuations of the funds' holdings that supported the inflated values.[345] However, the egregiousness of the conduct to manipulate the stock prices of the portfolio companies undermined these potential justifications.[346] The Court also spent time critiquing the valuation reports, noting, for example, that they did not follow standard appraisal practices and utilized baseless and unrealistic projections.[347] In short, the court found Lauer's valuations were unreasonably contrary to disclosed valuation methods.[348]

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(Sept. 10, 2012); Complaint, SEC v. ICP Asset Mgmt., No. 10-CIV-4791 (S.D.N.Y. filed June 21, 2010). For other examples, see Complaint, SEC v. Davis, No. 3:16-CV-00285 (W.D.N.C. June 2, 2016) (settled matter alleging failure to mark down value of defaulted loans in private fund portfolio); Complaint, SEC v. Summit Asset Strategies, No. 2:15-CV-01429 (W.D. Wash. Sept. 4, 2015); SEC Charges Seattle Area Hedge Fund Adviser with Taking Unearned Management Fees, Litigation Release No. 23334 (Sept. 4, 2015), https://www.sec.gov/litigation/litreleases/2015/lr23334.htm [https://perma.cc/9SDT-CW57] (filed as settled matter); SEC v. Balboa, No. 11 Civ. 8731(PAC), 2015 WL 4092328 (S.D.N.Y. July 6, 2015); *see also In re* Gilles T. De Charsonville, Exchange Act Release No. 77,937, 2016 WL 3030885 (May 26, 2016).

[339] *Lauer*, 2008 WL 4372896, at *12.

[340] *Id.* at *15.

[341] *Id.* at *19.

[342] *Id.*

[343] *Id.* at *5.

[344] *Id.*

[345] *Id.* at *6, *16.

[346] *Id.* at *25.

[347] *Id.* at *16. The court also described Lauer's own view of these valuation reports as "very creative." *Id.*

[348] *Id.*

Other cases do attempt to address an adviser's valuation procedures and methodology. For example, *Rockies Fund, Inc. v. SEC* (which arose out of an appeal of an administrative decision) involved a business development company—a type of unregistered closed-end investment company—which failed to disclose that it held restricted shares of an issuer in its portfolio.[349] As a result, the shares were valued as if they were free-trading shares.[350] However, the company's valuation policy required it to discount restricted shares.[351] Under these facts, the court upheld the Commission's decision and found violations of Section 10(b) and Rule 10b-5 of the Exchange Act.[352]

Valuation cases that scrutinize the adviser's valuation methodology have proven more challenging, even with Section 206(2) of the Advisers Act as a tool. For example, *SEC v. Mannion* provides an illustration of the difficulties in bringing such cases when there is some ambiguity—and the possibility of a court viewing the valuation as a subjective opinion.[353] *Mannion* involved an adviser that managed a private fund, which invested in illiquid and high-risk securities.[354] The largest investment in the fund involved a distressed publicly traded issuer.[355] In addition to holding common stock, the fund extended a bridge loan to the company after its bank cut off financial support.[356] The fund also held convertible debentures of the issuer.[357] Unsurprisingly, the condition of this company deteriorated.[358] The Commission's allegations included claims that the securities holdings' values were inflated, resulting in the adviser receiving excessive management fees.[359]

Like *Lauer*, the private placement memorandum of the fund in *Mannion* disclosed that the adviser had a great deal of discretion.

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[349] Rockies Fund, Inc. v. SEC, 428 F.3d 1088, 1096 (D.C. Cir. 2005).

[350] "Free-trading stock" refers to shares that can be traded without any limitation. *See* Finnerty, *supra* note 36; Van Vleet & Gerber, *supra* note 36.

[351] *Rockies Fund, Inc.*, 428 F.3d at 1092.

[352] *Id.* at 1098.

[353] SEC v. Mannion, No. 1:10-CV-3374-WSD, 2013 WL 1291621, at *8 (N.D. Ga. Mar. 25, 2013).

[354] *Id.* at *2.

[355] *Id.* at *2–3.

[356] *Id.* at *3 (noting that the lender cut off financial support because the CEO abruptly resigned, and the board announced an investigation into possible wrongdoing at the company).

[357] *Id.* at *2.

[358] *Id.* at *3.

[359] *Id.* at *1.

The adviser could adjust the value of illiquid securities to reflect "fair value," which could be "significantly higher or lower" than the actual value of the investment.[360] The Commission used an expert to argue that the holdings were overvalued.[361] The expert opined that the restricted stock holdings were overvalued by at least $1.7 million, but did "not offer an opinion on the extent to which the convertible debentures and bridge loans should have been discounted."[362]

The expert's inability to determine the amount of inflation in the securities' value proved detrimental to the case. On a motion for summary judgment, the court concluded that without such an estimate, it was impossible to prove that the inflated value was a material misrepresentation for purposes of the antifraud provisions in Section 206 of the Advisers Act and Section 10(b) and Rule 10b-5 of the Exchange Act.[363] The court did uphold the claim on the restricted stock, because the expert did opine on the amount of overvaluation.[364] However, the court cast some doubt on the strength of the Commission's case, noting that the overvaluation occurred in one month, and that the excessive management fee collected amounted to $2,107, 11 percent of the fees collected in the vehicle that held the investment "and a much smaller share of Defendants' overall fees for 2005."[365] After losing on a motion for rehearing,[366] the Commission filed a motion to dismiss the valuation claim entirely, and the Commission settled the matter over other conduct related to misappropriation.[367]

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[360] *Id.* at *3.

[361] *Id.* at *4.

[362] *Id.* The defense, coincidentally, also utilized an expert to justify the valuations. *Id.* at *6.

[363] *Id.* at *14.

[364] *Id.* at *10, *12.

[365] *Id.* at *12. The court also rejected the Commission's Section 10(b) and Rule 10b-5 claim because it found that the overvaluations were not in connection with any securities transactions. *Id.* at *11. The Commission could not show that anyone who later invested in the private funds received the inflated value. *Id.*

[366] *See id.* at *5.

[367] *See* SEC v. Mannion, 28 F. Supp. 3d 1304, 1306 (N.D. Ga. 2014). The Commission filed a similar action against Yorkville Advisors, LLC, which alleged that certain investments of convertible debentures, convertible preferred stock, and promissory notes in Yorkville managed private funds carried inflated values. *See* Complaint, SEC v. Yorkville Advisors, LLC, No. 12-CV-7728 (S.D.N.Y. Oct. 17, 2012). The case is not resolved, although the Commission has survived a Federal Rules of Civil Procedure Rule 12(b)(6) motion to dismiss. *See* SEC v. Yorkville Advisors, LLC, No. 12-CV-7728 (GBD) 2013 WL 3989054, at *4 (S.D.N.Y. 2013).

This outcome is not dissimilar to some private litigations discussed earlier.[368]

Valuation issues have periodically arisen in matters outside the context of investment advisers, business development companies, or related entities in SEC litigation. Generally, cases outside the adviser sector involve misvaluation as part of other broader, fraudulent conduct, such as an offering or accounting fraud.[369] The propositions in these cases also provide guides on both the potential avenues and limits of cases grounded in valuation claims.[370]

Values derived from projections are also a subject of litigation.[371] One court has suggested that empirical evidence that is inconsistent with a projection can serve as a basis for an action.[372] In *SEC v. Tecumseh Holdings Corp.*, a case concerning offering fraud, a company's projections of future performance were deemed misleading when past performance—which was not disclosed to investors—was inconsistent with the projection.[373] Generalized disclaimers that a projection was a forward-looking statement that may not come to fruition did not immunize the issuer from liability in *Tecumseh.*[374] Consistent with other private litigations, the court in *SEC v. Merchant Capital, LLC* supported the proposition that projections must be modified when subsequent events do not bear out the initial projection.[375] Thus, when a projection that was

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[368] *See supra* note 296 and accompanying text.

[369] *See, e.g.*, SEC v. Merchant Cap., LLC, 483 F.3d 747, 750 (11th Cir. 2007); Ponce v. SEC, 345 F.3d 722, 725 (9th Cir. 2003); SEC v. Tecumseh Holdings Corp., 765 F. Supp. 2d 340, 350 (S.D.N.Y. 2011).

[370] *See, e.g.*, *Merchant Cap.*, 483 F.3d at 771, 772; *Ponce*, 345 F.3d at 741; *Tecumseh Holdings Corp.*, 765 F. Supp. 2d at 344, 356.

[371] *See supra* note 321 and accompanying text.

[372] *Tecumseh Holdings Corp.*, 765 F. Supp. 2d at 354.

[373] *Id.* at 352–54.

[374] *See id.* at 350 (citing *In re* Time Warner Secs. Litig., 9 F.3d 259, 266 (2d Cir. 1993) (proposing that projections are "not beyond the reach of the securities laws")).

[375] *See, e.g.*, *Merchant Cap.*, 483 F.3d at 767–68; Hekker v. Ideon Grp., Inc., No. 95-681-Civ-J-16, 1996 WL 578335, at *1, *6 (M.D. Fla., Aug. 19, 1996). *Merchant Capital* also addressed disclaimers in the projections: "What may once have been a good faith projection became, with experience, a materially misleading omission of material fact. As the Fifth Circuit has recognized, '[t]o warn that the untoward may occur when the event is contingent is prudent, to caution that it is only possible for the unfavorable events to happen when they have already is deceit.'" *Merchant Cap.*, 483 F.3d at 769.

made in good faith initially does not appear to be achievable because of subsequent events, continued affirmation of the projection is actionable.[376]

Another case arising out of an appeal of an agency administrative decision, *Ponce v. SEC*, touched on accounting for an issuer's assets in a financial statement.[377] In *Ponce*, an accountant provided valuations for certain licenses and tooling that was reported in an issuer's financial statements.[378] He valued the licenses based on restricted shares another party exchanged to acquire the licenses.[379] Although he valued the restricted shares at a discount—about $4.7 million—the accountant was aware that the issuer later purchased the licenses for a substantially lower amount—about $125,000.[380] The accountant also treated tooling of a prototype as an asset rather than an expense, contrary to accounting guidance, further inflating the value of the issuer.[381]

The accountant in *Ponce* attempted to argue that his certification of the issuer's financial statements did not violate Section 10(b) and Rule 10b-5 of the Exchange Act.[382] In particular, he noted that his valuation methods were disclosed in the footnotes to the financial statements.[383] Although the court discussed that the valuation methodology was flawed,[384] it focused on the accountant's own doubts that the valuation was accurate. Among other things, the court noted the accountant "was fully aware of the problems associated with the valuation method he used," but "he nonetheless did not alter the valuation."[385] The accountant also admitted he had "reservations" about his valuation of the licenses, and he "believed [the issuer] could not sell them for the assigned value."[386]

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[376] *Merchant Cap.*, 483 F.3d at 769.

[377] Ponce v. SEC, 345 F.3d 722, 727–28, 731–32 (9th Cir. 2003).

[378] *Id.* at 726.

[379] *Id.* at 730.

[380] *Id.* at 726–27.

[381] *Id.* at 727.

[382] *Id.* at 729–30.

[383] *Id.* at 730.

[384] *Id.* at 731. The accountant's value was premised on the value of the stock on the date the licenses were initially acquired in a reverse merger transaction. *Id.* However, the court observed that the stock was "thinly traded." *Id.* After the purchase, the issuer acquired the shares for substantially less, casting significant doubt of the accountant's valuation method. *Id.*

[385] *Id.*

[386] *Id.*

## III. Understanding Court Approaches to Valuation and Alternatives

### *A. Court Review of Valuation Disputes and the Business Judgment Rule*

As the case law demonstrates, courts have grappled with disputes involving valuation matters by treating an adviser's value as a subjective opinion.[387] The approach of treating valuation in fraud cases as opinions provides a layer of deference to an adviser's valuation determination.[388] As a result, it should be no surprise that the successful valuation cases pursued in federal courts represent situations of fundamental breakdowns where the adviser is effectively operating a fraudulent enterprise or simply fails to undertake the valuation process represented to clients and investors.[389] Further, while certain valuation protocols—through statutory and rule-based requirements—are in place for registered funds, allowing for more scrutiny of the valuation process, no such guideposts exist for private fund investors.[390]

The courts' approach, however, often seems disconnected to the process-driven approach in many Commission actions. Rather than focus on the adviser's process in arriving at a valuation, courts tend to defer to the adviser as a valuation expert.[391] On its surface, this seems reasonable since an adviser's primary function is to identify investments that will ultimately appreciate. However, significant implications follow from an adviser's valuation determination, because the valuation sets out whether the client profits from the investment and how much compensation the adviser is entitled.[392] A lack of scrutiny offers room for abuse.

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387 Notably, the threshold issue of whether an opinion is a fraudulent statement in securities law appears in numerous other contexts. *See* Wendy Gerwick Couture, *Opinions Actionable as Securities Fraud,* 73 LA. L. REV. 381, 386 (2013). Valuations bear some distinction because of the central role of investment advisers in that process and the various statutes and rules governing valuations. *Id.*

388 *Id.* at 386–87.

389 *See* Bainbridge, *supra* note 14, at 87.

390 *See, e.g.*, Investment Company Act, 15 U.S.C. § 80a-1(a) (2012).

391 *See, e.g.*, Fait v. Regions Fin. Corp., 655 F.3d 105, 110 (2d Cir. 2011) (calculations of goodwill depend on management's judgment).

392 *See, e.g.*, Statement Regarding "Restricted Securities," Investment Company Act Release No. 5847, Fed. Sec. L. Rep. (CCH) ¶72,135 (1969) (finding valuation is "critically important" and determines investment managers' salaries).

Court deference in this area can be better understood by the challenge of assigning a value to complex or illiquid securities. Determining the value of a portfolio of large, liquid stock traded on the New York Stock Exchange is a relatively straightforward exercise. Alternatively, determining the value of restricted stock, complex derivative products, or a collection of other hard-to-value assets, involves an element of subjectivity that creates a range of possible values that often rely on the judgment of the adviser.[393] A client who contracts with an adviser relies on the adviser's skill in assessing a value as it is set out in the investment contract. Arguably, a court may be poorly placed to step into the adviser's shoes and make a post hoc judgment on the appropriate value of a hard-to-value security.[394]

The case treatment of valuation issues has a common law analog for corporate decision making.[395] The business judgment rule provides "a shield to protect directors from liability for their decisions."[396] As the Delaware Supreme Court explained, the business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[397] One commentator has described the business judgment rule as a "doctrine of abstention" that generally directs courts from refraining from reviewing a board's decisions "unless exacting preconditions for review are satisfied."[398]

The deferential judicial review of board decisions has policy justifications. Judge Winter summed them up in *Joy v. North*:

> First, shareholders to a very real degree voluntarily undertake the risk of bad business judgment. Investors need not buy

[393] *See, e.g.*, *Fait*, 655 F.3d at 108–11 (stating that there is no objective standard for determining the market value of assets).

[394] *See, e.g.,* Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) ("[C]ourts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions.").

[395] *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty,* 83 WASH. U. L.Q. 1017, 1030–32 (2005) (noting that courts have come to view mutual funds as corporations, but argues this is inappropriate).

[396] Gries Sports Enterprises Inc. v. Clev. Browns Football Co., Inc., 496 N.E.2d 959, 963–64 (Ohio 1984).

[397] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[398] Bainbridge, *supra* note 14, at 87.

> stock, for investment markets offer an array of opportunities less vulnerable to mistakes in judgment by corporate officers. Nor need investors buy stock in particular corporations. In the exercise in what is genuinely a free choice, the quality of a firm's management is often decisive and information is available from professional advisors. Since shareholders can and do select among investments partly on the basis of management, the business judgment rule merely recognizes a certain voluntariness in undertaking the risk of bad business decisions.
>
> Second, courts recognize that after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.
>
> Third, because potential profit often corresponds to the potential risk, it is very much in the interest of shareholders that law not create incentives for overly cautious corporate decisions. Some opportunities offer great profits at the risk of very substantial losses, while the alternatives offer less risk of loss but also less potential profit.... Given mutual funds and similar forms of diversified investment, courts need not bend over backwards to give special protection to shareholders who refuse to reduce the volatility of risk by not diversifying. A rule which penalizes the choice of seemingly riskier alternatives thus may not be in the interest of shareholders generally.[399]

Judge Winter's policy considerations for the business judgment rule[400] can handily be used as a rationale for the current court

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[399] 692 F.2d 880, 885–86 (2d Cir. 1982).

[400] Other commenters have provided similar descriptions of the fundamental rationale for the business judgment rule. *See, e.g.*, Todd M. Aman, *Cost-Benefit Analysis of the Business Judgment Rule: A Critique in Light of the Financial Meltdown,* 74 ALB. L. REV. 1, 11–20 (2010–11); Bainbridge, *supra* note 14, at 88–90; Clark W. Furlow, *Good Faith, Fiduciary Duties, and the Business Judgment Rule in Delaware,* 2009 UTAH L. REV. 1061, 1083–93 (2009); Richard Scarborough & Richard Olderman, *Why Does the FDIC Sue Bank Officers? Exploring the Boundaries of the Business Judgment Rule in the Wake of the Great Recession*, 20 FORDHAM J. CORP. & FIN. L. 367, 372–75 (2015); Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J.L. BUS. & FIN., 1, 8–12 (2010). Andrew Gold has framed the business judgment rule as an institutional choice against judicial intervention because of the uncertain benefits of higher court scrutiny. *See* Andrew Gold, *A Decision Theory Approach to the Business Judgment Rule:*

treatment of valuation disputes, especially in the context of private funds invested in illiquid securities. The Investment Company Act limits the pool of investors eligible to subscribe to private funds based on a minimum asset threshold or the number of investors.[401] The rationale is that such individuals can better withstand more risky investments and that they may be more sophisticated—and better equipped—to evaluate the merits of such an investment.[402] Further, the challenge of valuing an illiquid security creates a greater possibility of variation because information is imperfect. In the absence of tangible market data, there is greater reliance on modeling techniques and values of analogous securities.[403] Rather than creating a definitive price, a valuation under these circumstances may fall within a reasonable range of values—consistent with the Court's view of valuations in *Virginia Bankshares*.[404]

There are generalized critiques of the business judgment rule and arguments,[405] more particularly, that investment advisers and

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*Reflecting on Disney, Good Faith, and Judicial Uncertainty*, 66 MD. L. REV. 398, 470–74 (2007).

[401] Two provisions are commonly relied upon by funds to avoid the obligations under the Investment Company Act. Section 80a-3(c)(1) allows a fund to avoid these obligations if there are no more than 100 investors in the fund. *See* 15 U.S.C. § 80a-3(c)(1). Alternatively, an unlimited number of qualified investors can participate in a private fund. *See* 15 U.S.C. § 80a-3(c)(7). The term "qualified investor" provides various eligibility standards to participate in private funds, such as a requirement that an individual hold $5 million in investments. *See* 15 U.S.C. § 80a-2(51)(A). In addition, other limited exceptions may allow certain persons to participate in such funds without meeting the requirements of being a qualified investor. *See, e.g.*, 17 C.F.R. § 270.3c-5 (2012) (allowing certain knowledgeable employees of the adviser and others to invest). Other restrictions on the pool of private fund investors exist by virtue of the requirements to avoid registration obligations under the Securities Act. *See* Sklar, *supra* note 205, at 3278–79.

[402] Tamar Frankel's survey of Ponzi scheme victims and perpetrators suggests that wealthy and highly educated individuals also fall prey to such schemes despite legal assumptions that they are better equipped to assess complex investments. *See* TAMAR FRANKEL, THE PONZI SCHEME PUZZLE 143–45 (2012); *see also The Madoff affair: Con of the century,* ECONOMIST (Dec. 18, 2008) http://www.economist.com/node/12818310/ [http://perma.cc/XG8V-KHMC] [hereinafter *Madoff Affair*].

[403] *See, e.g.*, *In re* Salomon Analyst Level 3 Litig., 350 F. Supp. 2d 477, 491 (S.D.N.Y. 2004).

[404] 501 U.S. 1083, 1092–94 (1991).

[405] *See, e.g.*, Aman, *supra* note 400; Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 MINN. L. REV. 541 (2010); Sprague & Lyttle, *supra* note 400; *see also* J. Robert Brown, Jr., *The*

investment companies should not be treated in a similar fashion as other corporations.[406] Some commenters propose greater judicial scrutiny of board actions for all corporations in the wake of the recent financial crisis.[407] In the context of valuations, a business judgment rule-like approach that adheres closely to *Virginia Bankshares* and *Omnicare* introduces an element of caveat emptor for the advisory client to evaluate an investment opportunity.[408] Indeed, from the investor's perspective, penetrating an adviser's valuation in a private fund may be like attempting to peer into a black box. Moreover, private fund investors themselves, which often represent the interests of retirees, charitable organizations, and other financially unsophisticated individuals, are vulnerable to investment frauds.[409] In the wake of many recent financial frauds, some critics argue that financial regulators did not do enough to protect investors in private funds.[410]

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*Demythification of the Board of Directors*, 52 AM. BUS. L.J. 131, 195–96, n.314 (2015) (not critiquing the business judgment rule, but suggesting it as a possible catalyst for changes in corporate governance if courts applied it in a more intrusive fashion).

[406] *See, e.g.*, Birdthistle, *supra* note 311, at 787–90; Langevoort, *supra* note 395, at 1032–40.

[407] *See, e.g.*, Aman, *supra* note 400, at 44 ("The business judgment rule no longer appears justified on cost-benefit grounds."); *see also* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35 (2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2307959 [https://perma.cc/Q9QP-U78R] (arguing generally for enhanced corporate liability for risk-taking behavior). *Cf.* Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253 (2014) (arguing that an expanded legal duty concerning risk-taking administered by courts would be unwieldy).

[408] *See generally Va. Bankshares*, 501 U.S. 1083; Omnicare v. Laborers' Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318 (2015).

[409] *See, e.g.*, *Madoff Affair*, *supra* note 402.

[410] *See, e.g.*, Zelaya v. United States, No. 13-14780, 2015 WL 1402237 (11th Cir. Mar. 30, 2015) (Plaintiffs allege that the SEC's investigation into Stanford Ponzi scheme was inordinately delayed). In a similar vein, other commenters have criticized the SEC for failing adequately to police private funds. *See, e.g.*, J.W. Verret, *Review: Is Hedge Fund Registration Necessary?*, 70 WASH. & LEE L. REV. 705, 707–08 (2013) (critiquing regulatory response to Madoff and other frauds and suggesting this as a justification for questioning whether additional regulation in the field would better protect investors). An interesting point on this issue is whether there is a gap between expectations of government oversight in an area that was previously lightly regulated. One can view this as a form of government failure. *See* Barak Orbach, *What is Government Failure?*, 30 YALE J. REG. ONLINE 44, 53–55 (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2219709 [https://perma.cc/Q8H4-B7FG].

*B. A Process-Driven Approach for Valuation Disputes*

One alternative to address valuation disputes in the private fund space could be to empower courts to vary their scrutiny of an adviser's value of a portfolio security depending on the robustness of the adviser's valuation procedures. For more robust procedures, a court would limit its review to confirming that the adviser followed the disclosed procedures.[411] For more arbitrary procedures, such as a simple mandate to value securities based on the adviser's good faith, courts could scrutinize the actual value the adviser assigned with other relevant factors to determine whether the valuation is accurate.[412] This two-tier approach has an added benefit to incentivize advisers to adopt more robust valuation procedures in order to avoid greater court scrutiny. Courts and advisers already have a reference point for robust valuation procedures from best practices guides in the private fund space[413] and the valuation procedures in the Investment Company Act for registered investment companies.[414] At the same time, this approach frees advisers who

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[411] *See, e.g.*, Jones v. Harris Assos. L.P., 559 U.S. 335, 351 (2010) (reviewing the board's process to determine how adviser fees were set for claims involving Section 36(b) of the Investment Advisers Act).

[412] *See, e.g.*, SEC v. Mannion, 789 F. Supp. 2d 1321, 1334 (N.D. Ga. 2011) (finding the defendant's good faith valuation efforts subject to further examination in Rule 10b-5 litigation); Fraternity Fund Ltd. v. Beacon Hill Asset Mmgt. LLC, 376 F. Supp. 2d 385, 399 (S.D.N.Y. 2005) (upholding good faith standard in the examination to specific organization valuation policies); *In re* Allied Capital Corp. Sec. Litig., No. 02 Civ. 3812(GEL), 2003 WL 1964184 at *4 (S.D.N.Y. Apr. 25, 2003).

[413] *See, e.g.*, Int'l. Org. of Sec. Commissions, Principles for the Valuation of Collective Investment Schemes: Final Report (May 2013), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD413.pdf [http://perma.cc/8J9N-QGNF]; Hedge Fund Standards Board, The Hedge Fund Standards (May 11, 2015), http:// www.hfsb.org/wp-content/uploads/2016/04/Hedge-Fund-Standards-as-at-November-2015.pdf [https://perma.cc/5PLL-JE44]; Int'l. Org. of Sec. Commissions, Principles for the Valuation of Hedge Fund Portfolios: Final Report. (Nov. 2007), http://www.iosco.org/library/pubdocs/pdf/IOSCOPD253.pdf [https://perma.cc/ZE9M-CRST]; Asset Managers' Committee, Report of the Asset Managers' Committee to the President's Working Group on Financial Markets, Best Practices for the Hedge Fund Industry (Jan. 15, 2009), http://www.cftc.gov/idc/groups/public/@swaps/documents/file/bestpractices.pdf [https://perma.cc/PP54-5DSN]; Alternative Investment Management Association, AIMA's Guide to Sound Practices for Hedge Fund Valuation (Mar. 2007), https://www.aima.org/download.cfm/docid/71F28FFC-C3C7-41A7-9B3490B58652DA3A [http://perma.cc/L7EF-BQNJ].

[414] For example, courts could look to the Commission's guidance over certain types of hard-to-value securities in Accounting Series Releases 113 and 118. *Supra* notes 34–42 and accompanying text.

wish not to adopt such valuation practices to do so.[415] However, this proposed judicial approach requires a reinterpretation of the antifraud provisions and the creation of new substantive rights at least with respect to private claims.[416] Such modifications could be limited to rights either for the Commission to enforce or could be broadened to form a private right of action.

There are analogs that are suggestive of how courts could proceed under such an approach. Under Delaware corporate law, courts sometimes do not apply the business judgment rule in cases involving tender offers and other corporate takeover scenarios. In those situations, courts and commenters have recognized the possibility that a corporation's board of directors may have inherent conflicts of interest concerning a potential takeover, particularly in the context of competing bids.[417] Because of this conflict, Delaware courts scrutinize board decisions more rigorously than the business judgment rule depending on the circumstances.[418]

*Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* provides an example of the Delaware courts' heightened scrutiny.[419] In *Revlon*, a firm made an unsolicited tender offer to acquire Revlon.[420] After

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[415] *See supra* notes 34–42.

[416] Some antifraud statutes available to Commission enforcement actions do not require scienter as an element. In such cases, it is plausible for courts independently to determine that providing inaccurate valuations in the absence of an adviser's intent or recklessness to provide such a violation could be a breach of fiduciary duty. In contrast, the scienter element of other antifraud statutes, such as Rule 10b-5 of the Exchange Act, which are available to private parties, would require legislative and rule changes. *See* 17 C.F.R. § 240.10b-5.

[417] *See, e.g.*, Paramount Comm., Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) ("Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."); Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 788–89 (2006).

[418] *See* Bainbridge, *supra* note 417, at 802–04 (providing an analysis of the types of situations when a heightened standard of review may apply to a corporate takeover); *see also* Arnold v. Society for Sav. Bancorp, Inc., 650 A.2d 1270, 1289–90 (Del. 1990).

[419] 506 A.2d 173 (Del. 1986). The *Revlon* decision is a variant of heightened scrutiny involving defensive measures to prevent a hostile takeover. *Id.* Another formulation is expressed in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d. 946 (Del. 1985).

[420] 506 A.2d at 176.

taking a number of defensive measures to repel the offer, Revlon's board authorized the company to conduct negotiations with other potential bidders.[421] A white knight merger proposal emerged from a friendly party that was slightly more attractive than the initial tender offer.[422] The proposal had a lockup provision that precluded Revlon from considering other competing offers, effectively precluding the firm that made an unsolicited tender offer to enhance the terms of its proposal.[423] The *Revlon* court reviewed and upheld Revlon's various defensive tactics prior to the white knight's proposal.[424]

However, the *Revlon* court took a different—and much less deferential—view of the lockup provision:

> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the Unocal standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.[425]

The court invalidated the lockup provision.[426] The slight price improvement in the white knight's offer did not justify a provision that precluded continuing the auction for better bids.[427]

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[421] *Id.* at 177.
[422] *Id.* at 178.
[423] *Id.*
[424] *Id.* 180–81.
[425] *Id.* at 182.
[426] *Id.* at 184.
[427] *Id.* at 183–84. Commenters have often criticized *Revlon* for the potential breadth of a board's duty in being an "auctioneer." Delaware courts have subsequently clarified the case and do not require a board to hold an outright open auction. *See, e.g.*, Barkan v. Armsted Indus., Inc., 567 A.2d 1279, 1286 (Del. 1989) (noting that "no single blueprint" exists for a board to satisfy its obligations); Bainbridge, *supra* note 417, at 801–04; Franklin A. Gervutz, *Removing* Revlon, 70 WASH. & LEE L. REV. 1485 (2013); Lyman Johnson & Robert Ricca, *The Dwindling of* Revlon, 71 WASH. & LEE L. REV. 167, 190–91 (2014); Christina M. Sautter, *Promises Made To Be Broken? Standstill Agreements in Change of Control*

In situations where enhanced review is considered appropriate, Delaware courts focus on "the adequacy of the decision-making process employed by the directors" and, depending on the circumstances, conduct "a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing."[428] This second step may be avoided when the board's process was robust, and the board members who approved the transaction were disinterested.[429]

Similar federal court scrutiny applies to registered investment companies. The Investment Company Act, for example, places a fiduciary duty on investment advisers "with respect to the receipt of compensation for services" paid by a registered investment company.[430] Private plaintiffs as well as the Commission can bring actions[431] and need not prove "personal misconduct" but rather must prove "a breach of fiduciary duty."[432] Courts have set a fairly high bar in bringing such cases—requiring a showing that an investment adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[433] In evaluating a claim, the Supreme Court acknowledged, "a measure of deference to a board's judgment may be appropriate in some instances."[434] A key circumstance in determining the deference to

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*Transactions*, 37 DEL. J. CORP. L. 929, 942–43 (2013); Bernard S. Sharfman, *Shareholder Wealth Maximization and its Implementation under Corporate Law*, 66 FLA. L. REV. 389, 412 (2014).

[428] Paramount Comm. Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994).

[429] *See, e.g.*, Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009). *See also* Daniel J. Morrissey, *M&A Fiduciary Duties: Delaware's Murky Jurisprudence*, 58 VILL. L. REV. 121, 153–54 (2013) (discussing *Lyondell*).

[430] Investment Company Act, 15 U.S.C. § 80a-35(b) (2010).

[431] There has been a recent spate of private actions invoking Section 80a-35. These recent cases focus on two phenomena in the industry: the retention of the bulk of the management fees by an adviser when a sub-adviser performs most of the advisory function, and the question of whether an adviser is passing on the savings from economies of scale in retail funds relative to the fees institutional clients pay. *See Firms Fight Unprecedented Number of Excessive-Fee Suits*, FT IGNITES (Apr. 2, 2015) http://ignites.com/c/1089403 /115363?referr _module=SearchSubFromIG&highlight=Firms%20Fight%20"Unprecedented" %20Number%20of%20Excessive-Fee%20Suits [https://perma.cc/83SB-PWQD].

[432] Investment Company Act, 15 U.S.C. § 80a-35(b) (2010).

[433] Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 928 (2d Cir. 1982) (citations omitted).

[434] Jones v. Harris Assocs. L.P., 559 U.S. 335, 349 (2010).

afford a board's decision to accept a fee arrangement turns on process. When a board's process is robust, "a reviewing court should afford commensurate deference to the outcome of the bargaining process."[435] However, "where the board's process was deficient or the adviser withheld important information, the court must take a more rigorous look at the outcome."[436]

Commission enforcement action in the area of registered fund reviews of advisory contracts has focused more specifically on the process requirements in the Investment Company Act, typically referred to as the "15(c) process."[437] The Investment Company Act requires that the board of a registered investment company meet in person to conduct an annual review of the advisory contract.[438] A majority of independent directors must approve the contract.[439] Further, the directors have a duty to request and evaluate information, and the adviser has a duty to furnish information reasonably necessary to evaluate the contract.[440] The Commission has brought several settled administrative actions in this area that have typically focused on situations where the adviser allegedly failed to provide material information to a registered fund's board.[441]

Court scrutiny of valuation determinations in private funds based on the robustness of the adviser's procedures has limitations. For situations when courts grant great deference, it still leaves the possibility that objectively inaccurate valuations would not be subject to court scrutiny. At the other end, courts may find themselves scrutinizing complex valuations for which they are ill-equipped to judge.[442] In addition, developing a judicial benchmark for robust

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[435] *Id.* at 351.

[436] *Id.* at 336.

[437] *See* Investment Company Act, 15 U.S.C. § 80a-15(c) (2010). For cases covering this area, see *supra* note 434.

[438] *See* Investment Company Act, 15 U.S.C. § 80a-15(c).

[439] *See id.*

[440] *See id.*

[441] *See, e.g.*, *In re* Kornitzer Capital Mgmt., Inc., Investment Company Act Release No. 31560, 2015 WL 1800393 (Apr. 21, 2015) (settled matter); *In re* Chariot Advisors, LLC, Advisers Act Release No. 3872, 2014 WL 2986899 (July 3, 2014) (settled matter); *In re* Northern Lights Compliance Serv., LLC, Investment Company Act Release No. 30,502, 2013 WL 1835420 (May 2, 2013) (settled matter); *In re* Morgan Stanley Inv. Mgmt., Inc., Advisers Act Release No. 3315, 2011 WL 5562535 (Nov. 16, 2011) (settled matter).

[442] Courts have often struggled with valuation issues when questions arise with hard-to-value assets. For example, Delaware courts often struggle with

valuation procedures would require common law development, leaving advisers with some uncertainty over the strength of their own valuation procedures. The Delaware common law and 15(c) process also address somewhat distinct issues as compared to private fund valuation practices. Both areas involve discrete events.[443] *Revlon* situations occur during hostile corporate takeover attempts—a relatively rare event in a corporation's life.[444] The 15(c) process and the related fiduciary duty obligations of Section 36(b) is an annual event for the board of directors of registered investment companies.[445] In contrast, valuation determinations may be a daily event for advisers.[446] Elevated standards for valuation in this context could make the process cumbersome and costly if courts become too aggressive in their review.

Other possible alternatives exist to address valuations in private funds, but they may be much less desirable. For example, legislation and Commission rulemaking could establish valuation procedures not unlike those for registered investment companies.[447] However, this rules-based approach may lack the flexibility to address issues unique to private funds or to change as the area evolves. Another approach is to address the issue of limited judicial review indirectly without changing the approach of the courts. For example, Congress

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valuing minority shareholder stakes in situations where the shareholders are being squeezed out. *See, e.g.*, Gonsalves v. Straight Arrow Publishers, Inc., 793 A.2d 312, 315–16, 318 (Del. Ch. 1998), *aff'd in part & rev'd in part*, 725 A.2d 442 (1999); LeBeau v. M.G. Bancorporation, Inc., 1999 WL 44993 at *6–7 (Del. Ch. 1998), *aff'd in part & remanded in part*, 737 A.2d 513, 527 (Del. 1999). Such difficulties appear in other contexts. For example, the Surface Transportation Board determines whether a railroad charges a monopolistic freight rate by developing a complicated economic model based on what a hypothetical stand-alone railroad would charge. Like the valuation cases involving advisers, the Board's level of review was historically deferential to the railroad. *See* Salvatore Massa, *Injecting Competition in the Railroad Industry*, 27 TRANSP. L.J. 1, 19–22 (2000).

[443] Investment Company Act, 15 U.S.C. § 80a-15(c) (2010).

[444] 506 A.2d 173 (Del. 1990).

[445] Section 80a-15(a)(2) of the Investment Company Act limits the length of the advisory contract to two years, but nonetheless the contract may be continued if approved at least annually by the board or by vote of a majority of the outstanding voting securities. Investment Company Act, 15 U.S.C. § 80a-15(a)(2) (2010).

[446] The frequency of valuation can vary by the terms of a private fund's offering memorandum. In contrast, for open-end mutual funds, Rule 22c-1(b) requires daily valuation of the current net asset value of the fund. Investment Company Act, 17 C.F.R. § 270.22c-1(b).

[447] *See* 17 C.F.R. § 270.2a-1(c).

and the Commission could further limit the pool of investors who may be eligible to participate in private funds. Under the current legal framework, private funds seek exemptions from registration under the Securities Act and the Investment Company Act.[448] In order to meet these exemptions, the previous funds must ensure that investors meeting certain criteria participate in the private fund. At a minimum, investors must meet the requirement of being accredited investors,[449] and, in many instances, the investor must meet the higher standard of being a qualified investor.[450] These rules could be modified to target certain classes of investors who may be more severely impacted by a valuation dispute, such as pension funds.[451] Beyond identifying perceived vulnerable groups, the rules could raise net worth requirements or alternatively limit the amount of assets any investor could place into a private fund to avoid situations where the investor is "all in" on one investment. Under this approach, limiting the pool of eligible investors cabins the adverse impact of limited judicial review on investors.

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[448] Investment Company Act, 15 U.S.C. §§ 80a-3(c)(1), 80a-3(c)(7) (2010).

[449] Private funds operating under Section 3(c)(1) of the Investment Company Act are limited to offering the fund to no more than 100 investors. *See supra* note 401. Beyond the limitation in the number of investors, such funds will seek an exemption to the registration requirements of the Securities Act. The Securities Act provides such an exemption for offerings to accredited investors. *See id.*; 17 C.F.R. § 230.501 (2014). An "accredited investor" is defined under Rule 501(a) of Regulation D. Generally, for an individual to be an accredited investor, he or she must have earned income that exceeds $200,000 (or $300,000 together with a spouse) or must have a net worth of $1 million (excluding the value of the person's residence).

[450] See *supra* note 417 for a discussion on the qualified investor concept.

[451] Section 413(b)(2)(A) of the Dodd-Frank Act directed the Commission to review the accredited investor standard. *See* Net Worth Standard for Accredited Investors, SEC Release No. 3144, Securities Act Release No. 9177, Investment Advisers Act Release No. 3144, Investment Company Act Release No. 29,572, 2011 WL 231559, at 4–5 (Jan. 25, 2011), https://www.sec.gov/rules/proposed/2011/33-9177.pdf [https://perma.cc/R24R-XPE7]. Recent views on this topic have considered creating exceptions to the accredited investor standard. For example, the Division of Corporation Finance issued a report on the accredited investor standard suggesting opening up the exemption to certain individuals, including all entities with investments in excess of $5 million. U.S. SEC. & EXCHANGE COMM., REPORT ON THE REVIEW OF THE DEFINITION OF "ACCREDITED INVESTOR" (2015), https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf [https:// perma.cc/836Y-7FL3]; *see also* Michael S. Piwowar, Capital Unbound: Remarks at the Cato Summit on Financial Regulation (June 2, 2015) (transcript available at sec.gov), https://www.sec.gov/news/speech/capital-unbound-cato-summit.html#_ftnref9 [https://perma.cc/T4JM-UN2Y].

However, such rules are a blunt tool to address the narrower issue of limited judicial review. They risk limiting access to private funds to investors who are prepared to undertake the risks inherent in such investments, including limited judicial review. Like any possible detailed rules governing valuations, elaborate rules over the area may become obsolete as the characteristics of investors and private funds evolve.[452]

## CONCLUDING REMARKS

An investment adviser's valuation of assets for a client's account or for a pooled investment vehicle is one of the most critical functions an adviser performs that impacts fees and the returns the investor has reaped. It is unsurprising that the federal securities laws have developed extensive guidance for registered investment companies. Aside from limited guidance for registered investment companies, the legal framework for these funds has focused on process-driven requirements rather than forming objective standards on how an adviser should value a security. The process-driven approach never determines whether a valuation is per se inaccurate, rather it looks to the process of how the adviser made the valuation decision. This approach recognizes the limitations of regulators and courts in their ability to, on a de novo basis and with the benefit of hindsight, value a fund's portfolio assets—particularly hard-to-value securities.

There are potential areas that could be developed further in the enforcement of federal securities laws. One area—Section 206(2) of the Advisers Act—could be further developed to address the scope of an adviser's fiduciary duty over valuations. A second broader area is whether additional requirements and guidance over registered fund valuations should be utilized for private funds. Recent reforms in the federal securities laws moved toward convergence in adviser standards of conduct over registered investment companies and private funds.[453] Continued convergence may not be desirable,

[452] Tom Lin has observed that securities regulation has often approached investor protection by focusing on a homogenous concept for investors. *See* Tom C.W. Lin, *Reasonable Investor(s)*, 95 B.U. L. REV. 461, 464–65 (2015). He argues for a heterogeneous approach to crafting investor protection policies, recognizing that the expectations of investors vary along several different factors. *Id.* He focuses particularly on the rise of algorithmic investors and the need for flexible principles based regulation because of the risk of regulatory obsolescence. *Id.*

[453] Convergence reflects a continuation of recent securities laws reforms that have required registration of many private fund advisers. Prior to the

however, because registered investment companies and private funds have different investment mandates.

Unlike investors of mutual funds, investors of private funds stand on distinctly perilous ground. Although the Advisers Act provides some tangential requirements that affect valuations, successful cases brought by regulators center on situations of outright fraud—often involving situations where the adviser misrepresented their disclosed valuation procedures. Investors—who do not have standing to bring actions under the Advisers Act—must rely on antifraud concepts in federal courts. As a result, for private litigants challenging an adviser's valuation in federal court, opaque disclosed valuation procedures are likely to lead a court to defer to an adviser's valuation. The private fund valuation becomes a black box—a mystery that the ultimate investor cannot penetrate.[454]

To make matters worse, courts have elected to view valuation as opinions, providing advisers wide latitude in how they value securities. Although the opinion concept is expressed in these decisions, a better perspective of court treatment of adviser decisions is to view them like board decisions of a corporation and the concept of

implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, many private fund advisers were exempt from registration and largely avoided the obligations of the Advisers Act with the exception of the antifraud provisions. *See* 76 Fed. Reg. 42,950 (July 19, 2011) (to be codified in 17 C.F.R. pts. 275, 279). However, with only limited exception such advisers are now registered and subject to all of the obligations of the Advisers Act. *See supra* Section I.B.1. Another example of convergence is the requirement for advisers and registered investment companies to develop policies and procedures that are implemented together and complement each other. *See* 68 Fed. Reg. 72, 714 (Dec. 24, 2003) (request for comment 17 C.F.R. pts. 270, 275, 279).

[454] Although one could argue that the lack of transparency is the argument for investors not to participate in such funds, fees and performance may also be reasons. Fees and performance concerns have recently been cited as reasons for exits by large institutional investors from private funds. *See* David Oakley, *Investors lose the lovin' feeling for hedge funds*, FIN. TIMES (Sept. 21, 2014), https://www.ft.com/content/fad8fe2c-3fef-11e4-936b-00144feabdc0 [https://perma.cc/RZA8-FEB5] (noting that CalPERS, the Los Angeles Fire Fighters' and Police Officers' pensions system, the Louisiana Firefighters' retirement system, and the San Diego Country employees' retirement system have pulled out of such investments). Famed investor Warren Buffett is similarly a critic and is currently winning a friendly wager with a private fund manager that an S&P 500 Index fund will outperform a portfolio of private funds over a ten-year period—2008–2018. *See* Stephen Foley, *Warren Buffett versus the hedge funds*, FIN. TIMES (May 4, 2015), https://www.ft.com/content/946ade3c-f235-11e4-892a-00144feab7de [https://perma.cc/C37Y-9L6A].

the business judgment rule. In short, it is debatable whether courts have struck the right balance in evaluating valuation disputes.

Courts should approach valuation disputes differently. Deference to the private fund adviser's valuation should be based on the robustness of the adviser's valuation methodology. A process-driven approach gives deference to advisers who have developed and followed effective valuation procedures while scrutinizing those with more vague mandates in the valuation area. Courts have several reference points on how to demarcate robust valuation procedures and can draw from private fund industry groups as well as requirements for registered investment advisers. Such an approach recognizes the difficulty in valuing certain securities because it defers to advisers who have made the appropriate effort to reach an accurate value, while scrutinizing those where the potential for abuse is most likely. Courts have fallen short in this area in part because the legal infrastructure does not exist. However, the necessary changes are hardly radical extensions of existing concepts, such as the general concept that an adviser has a fiduciary duty to its client that has been recognized for well over fifty years.[455] A process-driven approach also avoids the more nettlesome questions regarding framing the specific scope of fiduciary duties around valuation that are now underway in other areas of law involving financial advisers.[456]

[455] SEC v. Cap. Gains Res. Bureau, Inc., 375 U.S. 180, 194 (1963).

[456] The U.S. Department of Labor has extended its fiduciary rules to pension and other advisers. *See* 81 Fed. Reg. 20,946 (Apr. 8, 2016) (to be codified at 29 C.F.R. pts. 2509, 2510, 2550). The new rules have generated a great deal of controversy and have spurred litigation. *See* Stephen Foley, *US makes concessions on retirement advice fees*, FIN. TIMES (Apr. 6, 2016), https://www.ft.com/content/89d44a66-fb72-11e5-8f41-df5bda8beb40 [https://perma.cc/T4XR-43CB]; *see also* Chamber of Commerce v. Perez, Case No. 3:16-CV-01476-G, (N.D. Tex., Complaint filed Jun. 1, 2016).