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# Putting Teeth Into the Compliance Rule: SEC Imposes US$5 Million Penalty on Investment Adviser for Valuation Practices

***The SEC's penalty against fixed-income manager Deer Park signals increased vigilance over investment advisers' valuation policies for client assets.***

On June 4, 2019, Deer Park Road Management Company, LP (Deer Park or the firm) agreed to settle Securities and Exchange Commission (SEC) charges stemming from Deer Park's violation of Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act) and Rule 206(4)-7 (the Compliance Rule) by agreeing to an SEC order imposing a US$5 million penalty and other relief (the Order).[1]

The SEC's Order and the underlying investigation are noteworthy for two reasons:

- First, the Order includes an unusually fine level of detail, demonstrating that the SEC closely scrutinized the firm's valuation policies and their implementation in the pricing of portfolio holdings, the use of pricing services, and the expertise of individuals tasked with oversight of the firm's valuation of portfolio securities.
- Second, the SEC charged the case as a stand-alone Compliance Rule violation, but imposed significantly larger financial penalties than the norm. The Order effectively puts new teeth into the Compliance Rule and raises the stakes in SEC examinations and enforcement investigations.

The Order is a reminder that investment advisers should take care to ensure that their valuation policies for client assets are tailored to their specific businesses, conform to Generally Accepted Accounting Principles (GAAP), and are properly implemented in practice.

## Background on the Deer Park Order

Deer Park is a private fund manager based in Colorado that manages over US$2.5 billion in assets and focuses on investments in distressed securities. Deer Park's flagship fund, STS Partners Fund LP (STS), primarily invests in non-agency residential mortgage-backed securities that originated before the 2008 financial crisis. From 2009 through 2015, STS was ranked as one of the most consistent, top-performing hedge funds in the country, producing returns over 20% each year through 2014 and providing 80 consecutive months of positive returns.

Based on the SEC's investigation into Deer Park's methods for valuing fund assets, the SEC found that Deer Park violated the Compliance Rule by failing to adopt and implement valuation policies and procedures reasonably designed to prevent the risk of federal securities law violations. The SEC also

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charged Scott Burg, the STS portfolio manager and Deer Park's primary trader at the time, with causing the firm's violations.

## The SEC's Findings

The SEC identified deficiencies in Deer Park's written policies for valuing client assets and in the implementation of those policies.

### Gaps in Written Policies

- Deer Park's policy stated that the firm would value securities at "fair value" in accordance with GAAP, which requires investment advisers to calibrate pricing models to current market conditions using observable market data.[2] Although Deer Park relied heavily on pricing models to determine fair value, the firm's pricing policies made no mention of the calibration requirement and lacked safeguards against inconsistent approaches to valuation or conflicts of interest present when traders set the value of securities in the portfolios they managed.

- GAAP also requires that an adviser's valuation methods maximize the use of relevant observable inputs such as market transactions and minimize unobservable inputs such as assumptions about inputs. However, Deer Park's pricing source protocol gave significant discretion to traders to choose between third-party pricing and internal pricing, which enabled them to undervalue assets and then mark securities up gradually instead of calibrating to the market price.[3]

- Deer Park also lacked policies addressing traders' communication with third-party pricing vendors about bond pricing, particularly for traders who challenged a price obtained from a pricing vendor. This policy gap enabled traders to provide vendors with inaccurate and incomplete information about the price at which Deer Park bought or sold a bond, which in turn could have impacted the mark provided by the pricing vendor.

### Deficient Implementation

- Although Deer Park's policies stated that traders must prioritize observable inputs such as market information, traders routinely failed to account for available trade information and marked bonds below recent trade prices. At one point, Deer Park bid US$28 to purchase a bond, received market information that the bond might trade in the low- to mid-US$40s, yet valued the bond using an internal price of US$11.21. Deer Park later received information from a broker that the bond was traded at the offer price of US$44.50, but the firm instead valued the bond at its internal price of US$20.18, noting that "[w]e can sell it for a profit when needed."

- As the STS portfolio manager, Burg approved the valuation for internally priced securities. Some of the trader explanations for the pricing approved by Burg demonstrated a failure to follow Deer Park's valuation policies. For example, traders flagged some bonds as "undervalued" with notations to "mark up gradually" rather than mark to market, violating Deer Park's valuation policies.

- Deer Park's Risk Management Committee, which was responsible for ensuring compliance with the pricing source protocol, was composed of individuals with no relevant experience in bond valuation.

## Key Takeaways

First, asset managers should take notice that the SEC is focusing more attention on funds' policies for valuing illiquid securities and whether asset managers effectively implement those policies. The conflict of

interest present when a manager values portfolio securities drives the SEC's interest in this space. This focus on deficient valuation policies appears to be a continuation of the Enforcement Division's 2017-18 sweep investigation of trades in non-agency mortgage-backed securities by fixed-income managers. The enforcement sweep investigation focused on possible prearranged trades in non-agency mortgage-backed securities and the resulting valuations of the securities traded. In Deer Park's case, the SEC focused exclusively on the valuation piece, carefully examining the finer details of Deer Park's valuation policy, its approach to third-party pricing sources, its actual valuation practices, and the technical expertise of the individuals with oversight responsibilities. While the Enforcement Division's scouring of Deer Park's valuation practices is more typical in an SEC examination, the Deer Park case demonstrates that the Enforcement Division has the bandwidth and expertise to flyspeck advisers' valuation of complex and illiquid securities.

Second, the Order indicates that the SEC is increasingly willing to use the Compliance Rule as a serious enforcement mechanism. Given the nature of the allegations, it is striking that the SEC found only a Compliance Rule violation, did not obtain any relief against the named portfolio manager besides a cease and desist order and a civil penalty, did not bring charges against any individual traders, and did not seek disgorgement of ill-gotten gains.

Despite the light charge, the magnitude of the civil penalties is noteworthy. The SEC imposed a US$5 million civil penalty against Deer Park and a US$250,000 penalty against Burg, amounts significantly greater than the norm. For enforcement actions over the past year in which the SEC has charged violations of the Compliance Rule, among other charges, the SEC has imposed an average civil penalty of US$1.74 million against investment advisers.[4] Penalties on settling individuals in that time frame generally ranged between US$15,000 and US$100,000, with an average penalty around US$85,000. For stand-alone Compliance Rule charges, the SEC generally obtains even lower penalties — with penalty amounts averaging roughly US$220,000 for firms and US$32,000 for individuals since 2011, when the agency first brought enforcement actions based solely on Compliance Rule violations.[5]

Accordingly, investment advisers should reevaluate their written valuation policies and implementation to ensure they are reasonably designed for their particular portfolios. Specifically, asset managers should:

- Take care with valuation policies and procedures that address which observable inputs must be considered
- Be mindful of the GAAP requirements to calibrate pricing models and maximize the use of relevant observable inputs to determine the fair value of securities
- Adopt policies that include guidelines regarding traders' communications with pricing vendors when such communication can influence third-party pricing
- Ensure that the individuals tasked with oversight of valuation have properly specialized expertise, particularly when the manager's strategy includes investing in illiquid fixed-income securities
- Make certain that traders and portfolio managers adhere to the firm's written policies

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**Endnotes**

[1] In re Deer Park Road Management Company, LP, and Scott E. Burg, Administrative Proceeding File No. 3-19190 (June 4, 2019), *available at*: https://www.sec.gov/litigation/admin/2019/ia-5245.pdf.

[2] This requirement is set forth in Accounting Standards Codification 820-10-35-36 and Accounting Standards Codification 82-10-35-24C.

[3] The pricing source protocol allowed traders to deviate from third party pricing vendors' bond valuations within a specified range, and at times, deviate entirely and select a price set by Deer Park traders instead. For example, Deer Park valued one bond using an external pricing source until the pricing vendor raised the price, at which point Deer Park traders determined that it was "too low yield at new price, move to internal," and switched the bond to internal pricing.

[4] These averages were calculated by first identifying all SEC Enforcement Actions in Wolters Kluwer's Cheetah legal database from June 1, 2018 to June 1, 2019 that mention "206(4)-7."

[5] Press Release, U.S. Securities and Exchange Commission, SEC Penalizes Investment Advisers for Compliance Failures (Nov. 28, 2011), https://www.sec.gov/news/press/2011/2011-248.htm.