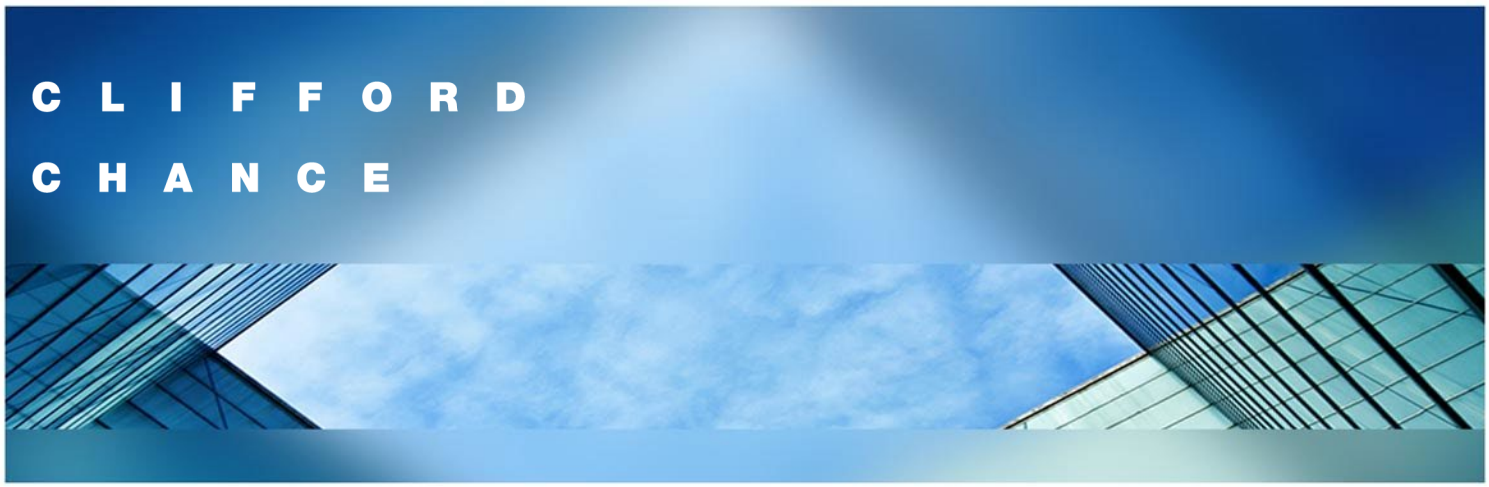

RECENT SEC ENFORCEMENT ACTIONS HIGHLIGHT THE IMPORTANCE OF SOUND VALUATION AND DISCLOSURE PRACTICES BY INVESTMENT MANAGERS

The U.S. Securities and Exchange Commission ("**SEC**") recently obtained a final judgment of over $30 million against a registered investment adviser for inaccurate disclosures based on its use of false and misleading track record information in violation of the Investment Advisers Act of 1940 (the "**Advisers Act**").[1] The action against Navellier & Associates, Inc. ("**Navellier**") followed two prior enforcement actions against registered investment advisers—Old Ironsides Energy, LLC ("**Old Ironsides**") and Everest Capital LLC ("**Everest**")—for private fund marketing disclosure violations.[2] In addition, a recent Risk Alert by the SEC's Office of Compliance Inspections and Examinations ("**OCIE**") identified inaccurate valuations as a recurrent finding in OCIE private fund adviser examinations.[3] These recent developments underscore the SEC's continued focus on ensuring that investment managers accurately value portfolio holdings and clearly and accurately disclose fund and manager performance—requirements that are increasingly challenging since the outbreak of COVID-19.

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1 *SEC v. Navellier & Associates, Inc., and Louis Navellier*, Lit. Rel. No. 24826 (June 4, 2020), https://www.sec.gov/litigation/litreleases/2020/lr24826.htm.

2 *Everest Capital LLC*, Investment Advisers Act of 1940 Release No. 5491 (April 30, 2020), https://www.sec.gov/litigation/admin/2020/ia-5491.pdf; *Old Ironsides Energy*, LLC, Investment Advisers Act of 1940 Release No. 5478 (April 17, 2020), https://www.sec.gov/litigation/admin/2020/ia-5478.pdf.

3 U.S. Securities and Exchange Commission, OCIE, National Exam Program Risk Alert: Observations from Examinations of Investment Advisers Managing Private Funds (June 23, 2020), https://www.sec.gov/files/Private%20Fund%20Risk%20Alert_0.pdf.

CONTINUED SEC FOCUS ON PERFORMANCE MARKETING

OCIE has consistently identified common deficiencies in asset valuation and performance disclosure during examinations, highlighting certain recurrent themes for private funds, including:

- Inflated valuations during periods of fundraising;
- Valuation methodologies that differ from those described in a fund's limited partnership agreement ("**LPA**");
- Improper accounting maneuvers;
- Using different valuation methodologies from one period to another;
- Cherry-picking comparables; and
- Using projections instead of actual valuations without proper disclosure.[4]

In 2017, OCIE issued further guidance to investment advisers cautioning against the use of unclear marketing disclosures and valuation issues, while identifying frequent compliance deficiencies, including:

- Misleading performance results;
- Misleading one-on-one presentations;
- Misleading claims of compliance with voluntary performance standards (*e.g.*, GIPS);
- Cherry-picking of profitable stock selections;
- Misleading selection of investment recommendations; and
- Failing to maintain or implement compliance policies and procedures.[5]

Most recently, in June 2020, OCIE issued a Risk Alert discussing compliance issues observed in examinations of private fund managers. One key aspect stressed by OCIE was the failure by examined managers to value assets in accordance with their disclosed valuation process, leading, in some cases, to fund holdings being overvalued and, consequently, managers receiving inflated management fees and carried interest.[6]

As evidenced by the above guidance, the SEC—including both OCIE and the Enforcement Division—continues to focus on valuation and marketing—a point that is only further emphasized by the recent SEC enforcement actions in this area. Actions against Navellier, Old Ironsides and Everest are the latest reminder of the SEC's focus on these issues.

OLD IRONSIDES

The SEC recently settled an enforcement action against Old Ironsides, a private fund adviser, on allegations that its marketing materials were deficient because of inaccurate valuations of prior investments. Specifically, the SEC alleged that

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4 *See, e.g.*, Andrew J. Bowden, Director, OCIE, Spreading Sunshine in Private Equity (May 6, 2014), https://www.sec.gov/news/speech/2014--spch05062014ab.html.

5 *See, e.g.*, U.S. Securities and Exchange Commission, OCIE, National Exam Program Risk Alert: The Most Frequent Advertising Rule Compliance Issues Identified in OCIE Examinations of Investment Advisers (September 14, 2017), https://www.sec.gov/ocie/Article/risk-alert-advertising.pdf.

6 *See supra* note 3.

marketing materials for Old Ironsides Energy Fund II LP ("**OIE Fund II**") included a positive historical track record that was driven primarily by investments that the marketing materials stated would not be part of the OIE Fund II portfolio.[7]

According to the SEC, Old Ironsides miscategorized a high-performing investment in a private fund managed by a third-party advisor (and not Old Ironsides) as a direct investment in an oil and gas drilling operator (referred to in the OIE Fund II marketing materials and LPA as an early stage direct drilling investment or "**DDI**"). The SEC explained that Old Ironsides represented in its marketing materials that it would not invest in other private funds as part of the OIE Fund II investment strategy. Moreover, the SEC found that by categorizing the third-party fund investment as a DDI, Old Ironsides significantly improved the track record for its DDIs, as the other early stage DDIs had a "much lower" return on investment. The SEC concluded that Old Ironsides willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-1(a)(5) thereunder, which make it a fraudulent, deceptive or manipulative act, practice, or course of business to, among other things, directly or indirectly publish, circulate, or distribute an advertisement which contains any untrue statement of material fact, or which is otherwise false or misleading. The level of granularity involved in the allegations of deficient disclosure in this action demonstrates that the SEC's focus in reviewing past performance information will not be limited to high-level deficiencies.

The SEC also noted that at the time Old Ironsides drafted the marketing materials for OIE Fund II, it had in place, but failed to follow, policies and procedures prohibiting: (i) the distribution of advertisements that include untrue statements or omissions of a material fact or which are otherwise false or misleading; and (ii) the use of performance results in marketing materials that are false or misleading, including "misleading depictions of investment performance in both form and content leading to direct or indirect implications or inferences arising out of the context of the marketing materials." The SEC concluded that Old Ironsides violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, by failing to implement policies and procedures reasonably designed to prevent Advisers Act violations.

EVEREST

Everest's April 2020 SEC settlement relates to allegations of acts inconsistent with investment concentration and risk controls disclosures in managing the Everest Capital Global Fund, L.P. (the "**Everest Fund**"). Specifically, the SEC alleged that Everest prepared marketing presentations for prospective investors that made misleading disclosures about the Everest Fund's gross exposure and risk management policies.

According to the SEC, from September 2014 to January 2015, Everest made highly concentrated investments in the euro to Swiss franc exchange rate (the "**EUR/CHF Position**").[8] The SEC alleged that the Everest Fund's gross notional currency exposure in these investments ranged from approximately 400% to over 900% of the Fund's assets, bringing the Fund's total gross exposure to over 1300%. During

7 The historical track record for OIE Fund II was related to investments that Old Ironsides' principals managed for a previous employer.

8 Starting in January 2011, the Swiss National Bank capped the exchange rate at 1.20 francs to the euro and issued periodic statements declaring its intent to maintain the cap.

this time period, however, the Everest Fund's marketing presentations disclosed that the Fund's gross exposure was approximately 155% to 185%. However, the presentations omitted an explanation that the disclosed gross exposure range excluded currencies—including the EUR/CHF Position. As a result, the SEC alleged that Everest's failure to accurately disclose the Everest Fund's gross exposure misled investors as to the extent of the Fund's highly concentrated currency position.

In addition, Everest's marketing presentations stated that its risk management team "monitors all mandated risk limits of each strategy," "enforces strict adherence to these limits," and can "reduce risk independent of the investment team." Everest's internal risk protocols did not, however, include currencies, meaning that the risk management team could not subject currency trades to risk monitoring, limits, review, or to any independent risk reduction measures. As a result, the SEC asserted that Everest failed to disclose to investors that the risk management team lacked the ability to independently reduce currency-related risks, such as the EUR/CHF Position.

On January 15, 2015, the Swiss franc rose more than 30% versus the euro when the Swiss National Bank removed a 1.20 exchange cap. In short order, the Fund's counterparties forced Everest to liquidate its positions due to margin calls; the Fund sustained losses exceeding the Fund's assets; and, days later, Everest dissolved the Fund.

Based on the alleged conduct, the SEC found Everest violated Section 206(2) and Section 206(4) of the Advisers Act and Rule 206(4)-8 thereunder and subjected Everest to penalties, including disgorgement of $2 million and a civil money penalty of $750,000.

NAVELLIER

The SEC obtained a final judgment against Navellier and its founder on June 2, 2020. The judgement stemmed from an August 2017 civil complaint[9] alleging that the Navellier defrauded clients by, in part, providing materially false and misleading track record information for its "Vireo AlphaSector" investment strategy (the "**Vireo Strategy**").

The SEC alleged that from May 2010 through August 2011, Navellier used marketing materials claiming that the Vireo Strategy tracked real-time investment decisions that significantly outperformed the S&P 500 Index between 2001 and 2008. Navellier's marketing materials also stated that the historical performance shown for the Vireo Strategy was not "back-tested."[10] The SEC alleged that both assertions were false—the Vireo Strategy did not exist from 2001 to 2008 and thus could only be created through back-testing, and Navellier used its back-testing to artificially inflate the Vireo Strategy's performance.

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9 Complaint, *SEC v. Navellier & Associates, Inc.*, No. 17-cv-11633 (D. Mass. August 31, 2017), https://www.sec.gov/litigation/complaints/2017/comp23925.pdf.

10 Back-testing is the application of a quantitative model to historical market data to generate hypothetical performance during a prior period. Managers who present back-tested performance can use the benefit of hindsight to create misleading marketing materials that suggest, for example: (i) that the manager made profitable investment decisions in the past when they might not have without the benefit of hindsight; or (ii) that investment models or approaches used in historical market conditions will generate similar returns in the present or the future. The use of back-tested performance is not always misleading, but it must be accompanied by clear explanation and disclosures about its assumptions and limitations.

On February 13, 2020, a Federal district court granted the SEC's motion for summary judgment that Navellier violated Sections 206(1) and 206(2) of the Advisers Act. The court found, among other things, that the defendants marketed the Vireo Strategy based on false claims, lacked documentation to support the performance claimed, and knew that their claims were false—none of which was disclosed to Vireo's clients. The court ordered Navellier to pay a penalty of over $30 million.

FUND MANAGERS MUST REVIEW MARKETING DISCLOSURES

These recent SEC enforcement actions illustrate the SEC's commitment to policing the use of prior performance by fund managers. This risk is especially heightened now, due to the market uncertainty created by COVID-19 and the difficulty of valuing fund assets, particularly illiquid assets. Fund managers should consider taking the following steps now to help address these risks:

- Closely review existing marketing materials and disclosures to ensure that information is not presented in a manner to elicit from an investor, either directly or indirectly, an improper inference relating to prior, current, or projected investment performance.
- Exercise particular caution when using "back-tested" or other forms of hypothetical performance, as well as projected performance. The SEC will closely scrutinize such performance in examinations and will expect clear disclosures about how the performance was calculated and all limitations of the calculation methodology.[11]
- When discussing legacy investments or investment strategies in marketing materials, confirm that they are similar in nature to those used by the fund being marketed.
- Carefully review statements in marketing materials to confirm their accuracy and that they align with the manager's actual valuation and investment practices for the fund and with the fund's LPA.
- Clearly disclose the manager's role and its staff with respect to specific investments, investment strategies, and the performance of the investments and strategies.
- Maintain clear and substantive back-up for all performance information presented in marketing materials. Back-up is particularly important for back-tested and other forms of hypothetical performance, as well as fair market valuations and future performance calculations.
- Review compliance policies to confirm effective procedures are in place to prevent the disclosure of inaccurate or misleading performance information and to retain necessary records. The manager's staff, particularly those involved in drafting marketing materials, should be properly informed and trained to implement such policies and procedures.

[11] *See, e.g., Sterling Global Strategies*, Investment Advisers Act of 1940 Release No 5085 (December 20, 2018), https://www.sec.gov/litigation/admin/2018/ia-5085.pdf; *Massachusetts Financial Services Company*, Investment Advisers Act of 1940 Release No. 4999 (August 31, 2018), https://www.sec.gov/litigation/admin/2018/ia-4999.pdf.

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