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"Mismarking": Developments In Valuation Fraud

By Telemachus P. Kasulis

One of the central business functions performed by an investment fund is the valuation of its positions. Knowing how much its investments are worth allows a fund to redeem investors at accurate levels, demonstrate performance to prospective investors, and charge an appropriate amount in fees. And while some positions can be easy to value — one need look no further than Bloomberg or the Wall Street Journal to know the going rate for, say, Apple stock — more exotic or illiquid holdings can present a challenge for even the most conscientious fund.

They also present an opportunity for fraud. At least according to the Department of Justice (DOJ), which has aggressively targeted valuation or "mismarking" fraud in a number of indictments brought within the last few years. But while these cases create headlines, these are far from easy prosecutions. Recent cases demonstrate the hurdles prosecutors must overcome and the effective defenses that can be raised when so much at trial comes down to whether reasonable judgment and good faith were used in marking a fund's books. And as the DOJ expands its mismarking inquiries beyond stocks and bonds and into areas like private equity, these cases also illuminate the increasing need for robust internal controls designed to eliminate the incentives for an employee or manager to overvalue assets.

Lumiere: "Overriding" the Pricing Services and the Motives to Mismark

From 2011 through 2013, Stefan Lumiere worked at hedge fund Visium Asset Management, which at its peak had a net asset value of approximately $8 billion. Lumiere was a senior analyst and a portfolio manager responsible for a significant portion of Visium's credit fund, which invested principally in bonds and other debt instruments. Like many investment professionals, Lumiere received a percentage of the profits he made on winning positions in the fund.

Many of the bonds in the fund were significantly illiquid — that is, purchases and sales of the bonds were rare. This made valuation tricky. Visium's back office would obtain best estimate market prices from a third-party pricing service, like Markit. But members of the investment team like Lumiere could "override" the pricing service by providing support for their preferred valuation. For example, a quote from an outside broker that it would buy or sell the bond at a given price would suffice.

Lumiere and others at Visium abused this system. Motivated to overvalue their positions to increase profits, they obtained inflated price quotes from corrupt brokers eager to handle transaction flow for a significant fund like Visium. Prosecutors in the Southern District of New York showed at Lumiere's 2017 trial that the brokers frequently did no research on the bonds in question and simply parroted back the price Lumiere suggested. Indeed, Lumiere obtained "independent" broker quotes that valued certain debt positions at almost three times that listed by the pricing services. Unsurprisingly, all of this was inconsistent with the way Visium had described its valuation process to investors and Lumiere was convicted of securities fraud and other offenses.

Good Faith and the Importance of Insiders

Critical to the case against Lumiere had been the testimony of other participants in the scheme, who strongly rebutted any suggestion that Lumiere had truly believed in the value of his marks. The importance of this kind of insider testimony in mismarking cases was

Telemachus P. Kasulis is a partner at Morvillo Abramowitz Grand Iason & Anello PC.

reinforced by two recent valuation trials conducted within months of each other earlier this year.

In May 2019, prosecutors in the Eastern District of New York tried three senior executives at the Platinum Partners hedge fund for allegedly deceiving investors about, among other things, the value of various oil and gas company securities held by the fund. The defendants, like Lumiere before them, argued Platinum had reasonably relied upon third-party pricing services to help mark positions. In addition, they argued that various negative events associated with the underlying energy companies at issue had been disclosed to Platinum investors.

Although the government called a number of witnesses from inside the fund, none could testify that the defendants intentionally overmarked their assets. While the prosecutors relied on emails that demonstrated the defendants may have known that the energy companies were struggling — and that this could theoretically impact the value of the underlying securities — no witness or document could effectively close the loop and show the defendants were not acting in good faith. The court ultimately precluded the prosecutors from arguing to the jury that mismarking had occurred, observing that the government had provided no qualified witness to undermine the valuations at issue. All three defendants were ultimately acquitted of the charged scheme to defraud Platinum investors, although two were convicted for unrelated conduct.

The next month, jurors in the Southern District of New York reached a very different conclusion in the trial of Premium Point Investments (PPI) founder Anilesh Ahuja and trader Jeremy Shor. Prosecutors alleged that Ahuja, Shor, and others orchestrated a large mismarking scheme at PPI — at times overstating the net asset value by more than $200 million. As in the other cases, the defendants allegedly mismarked to increase PPI fees and defray investor redemption requests. Like Visium and Platinum, PPI employed a back office function to mark positions which relied in significant part on data from pricing services. Traders were allowed to "challenge" proposed valuations in a manner similar to that at Visium.

Ahuja and Shor defended themselves at trial largely by arguing that if any securities had been mismarked it had been done by others and without their knowledge or meaningful participation. Unlike in the Platinum trial, however, prosecutors were able to call three other members of the scheme as witnesses to place the trial defendants in the middle of the conspiracy. The cooperating witnesses described in detail how the conspirators worked to undermine the valuation controls through obtaining fraudulent broker quotes and tinkering with asset valuation methodology, leaving little doubt that the defendants had not acted in good faith or exercised reasonable judgment in valuing the fund's positions. The jury convicted both defendants on all counts after a single day's deliberations.

Conclusion

There is no reason mismarking should be limited to stocks and bonds. Indeed, this year prosecutors in the Southern District of New York charged several executives of Dubai private equity firm Abraaj Capital Ltd. with criminal RICO offenses, claiming that they had deceived investors about the performance of Abraaj portfolio companies as part of a pattern of racketeering activity. The indictment noted that estimates of the related loss have exceeded a billion dollars.

During the same period, prosecutors also accused the founder and chief executive officer of Live Well Financial, Inc. with helming a scheme to overvalue a portfolio of mortgage bonds valued in the hundreds of millions of dollars. The SDNY U.S. Attorney's Office announced that the chief financial officer and head trader have both pled guilty and are cooperating with the government.

With the government's charge against mismarking showing no sign of abating, the defense of these cases will likely depend upon the ability of the defendants to discredit the cooperating witnesses while demonstrating that they acted in complete good faith. Showing that their funds made best efforts to implement robust valuation and controls systems won't hurt either.

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