



## SEC Enforcement Matters

# Charges of Fraudulent Valuation, Insider Trading and Failure to Supervise Employees Cost Manager and CFO More Than \$10 Million in SEC Settlement

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The SEC recently issued settlement orders against [Visium Asset Management, LP](#) (Visium) and its chief financial officer, [Steven Ku](#), in connection with alleged insider trading and fraudulent valuation practices by former Visium partner and portfolio manager Sanjay Valvani and former portfolio managers Christopher Plaford and Stefan Lumiere. The SEC charged that, by virtue of the portfolio managers' misconduct, Visium violated the antifraud and compliance provisions of the federal securities laws and Ku allegedly failed to supervise Plaford and Lumiere. This article analyzes the terms of the settlements.

For another recent enforcement action involving improper valuation, see "[Hedge Fund Platinum Partners and Principals Face Civil and Criminal Proceedings From SEC and DOJ Over Alleged Fraudulent Valuation Practices and Liquidity Misrepresentations](#)" (Jan. 12, 2017). For more on actions involving inadequate insider trading policies and procedures, see "[Will Inadequate Policies and Procedures Be the Next Major Focus for SEC Enforcement Actions?](#)" (Nov. 30, 2017). For another SEC action involving a failure to supervise, see "[Despite His 'Bad Acts,' Issuers Beneficially Owned by Steven A. Cohen Are Not Precluded From Private Offerings Based on the Bad Actor Rule](#)" (Jan. 21, 2016).

## Relevant Parties and Background Information

Visium has been an SEC-registered investment adviser since 2011. At its peak, it had more than \$7.8 billion in assets under management. Visium served as investment adviser to Visium Credit Master Fund, Ltd. and its offshore and onshore feeder funds (together, Credit Fund) and to Visium Balanced Master Fund, Ltd. and its feeders (together, Balanced Fund). At relevant times, Ku served as Visium's chief financial officer and as a member of its valuation committee. He later served as the firm's chief operating officer.

In 2016, the SEC commenced a [civil enforcement action](#) against Valvani and Gordon Johnston, a former official of the U.S. Food and Drug Administration's Office of Generic Drugs (OGD). The SEC accused them of violating the anti-fraud provisions of the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act) by reason of the alleged

insider trading outlined below. Johnston **settled** those charges in November 2016. The SEC dropped its case against Valvani after Valvani's death in June 2016.

For the details of the enforcement action against Valvani and Johnston, along with further details of the insider trading and mismarking schemes discussed below, see "[SEC Continues to Focus on Insider Trading and Fund Valuation](#)" (Jun. 30, 2016).

Separately, in 2016, the SEC commenced a parallel **civil enforcement action against Plaford**, accusing him of violating the anti-fraud provisions of the Investment Advisers Act of 1940 (Advisers Act) and the Exchange Act by engaging in both the mismarking scheme and the insider trading detailed below. It brought a parallel **enforcement action against Lumiere** for his participation in the mismarking scheme.

Plaford pled guilty, and Lumiere was convicted at trial, for the alleged misconduct. Lumiere has been sentenced to 18 months in prison and three years' supervised release and must pay a \$1 million fine. The SEC recently barred **Lumiere** from the securities industry. It has deferred action on Plaford pending his sentencing and the conclusion of the criminal case against him.

## Mismarking Scheme

According to the SEC, from July 2011 through December 2012, Plaford and Lumiere repeatedly used sham broker quotes and other illicit methods to value thinly traded bonds in the Credit Fund's portfolio. They allegedly obtained sham quotes on 308 occasions in order to override prices supplied by the Credit Fund's administrator or when the administrator did not provide pricing from established sources.

On those occasions, Plaford and Lumiere would tell one or more "friendly" brokers that they needed a specific quote for a given security. The broker(s) would then email or instant message the requested quote back to Lumiere or Plaford as if it were the broker's own genuine quote.

Over 91% of the 308 price overrides resulted in an increase in the value of the Credit Fund's position in a bond which, in turn, increased the fund's net asset value (NAV). In addition, on at least two occasions, Plaford and Lumiere caused the Credit Fund to purchase more of a bond that it already owned at an above-market price in order to inflate the value of the entire position and, as a result, the fund's NAV.

See "[SEC Settlement Suggests that Prime Brokers Have Due Diligence and Disclosure Obligations with Respect to Manager-Provided Hedge Fund Valuations](#)" (Jul. 16, 2015).

The SEC claimed that the mismarking scheme resulted in the improper inflation of the Credit Fund's 2011 year-end NAV by more than 5% and its 2012 year-end NAV by about 7%. This allegedly generated "\$2,622,709 in ill-gotten performance fees . . . and \$533,700 in ill-gotten management fees" for Visium. Visium also reported inaccurate NAV information in its Forms ADV.

The sham broker quotes also enabled Plaford and Lumiere to mischaracterize certain bonds as "Level 2" assets (which can be valued using observable market inputs) rather than "Level 3" assets (which have no observable market inputs). The Credit Fund's administrator provided that inaccurate information to the Fund's investors.

Valuation of hard-to-value assets is a perennial SEC focus. See "[Steps Advisers Can Take to Minimize the Risk That a Routine SEC Examination Ends With a Referral to Enforcement: Five Key Priorities for OCIE \(Part One of Two\)](#)" (Jan. 4, 2018); and "[Ten Key Risks Facing Private Fund Managers in 2017](#)" (Apr. 6, 2017).

See also “[SEC Settlement With PIMCO Highlights the Importance of Proper Valuation and Performance Disclosures](#)” (Dec. 8, 2016).

## Misleading Statements to Investors

According to the SEC, Visium made materially misleading statements to its investors and prospective investors concerning its valuation practices. Specifically, Visium claimed that:

- it would “fair value” assets in accordance with generally accepted accounting principles [See “[Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations](#)” (May 11, 2017).];
- its pricing would be done by an accounting team that is independent of its traders and portfolio managers;
- its independent administrator would calculate NAV using “established pricing sources” [See “[Is the Use of an Independent Valuation Firm Superior to a Manager’s Internal Valuation Process?](#)” (Apr. 23, 2015).];
- it could override the administrator’s pricing only when (1) that pricing was inconsistent with fair value; and (2) the override was based on reliable and independent sources, preferably “at least three dealer marks”; and
- its valuation committee was required to evaluate all non-standard pricing of assets and to document its findings.

For more on valuation and valuation committees, see “[Three Pillars of an Effective Hedge Fund Valuation Process](#)” (Jun. 19, 2014).

In practice, however, Plaford and Lumiere supplied pricing information to Visium’s back office, which inputted the information into a spreadsheet and sent it to the Credit Fund’s administrator. The administrator then populated the spreadsheet with prices from third-party pricing sources. When Plaford and Lumiere desired to override the administrator’s mark, they would send sham quotes to the Fund’s back office, which the back office used.

Advisers must always adhere strictly to the valuation and fee calculation methodologies disclosed to fund investors. See “[Failure to Ensure Portfolio Value Calculations Comport With Disclosed Methods May Bring SEC Enforcement Action, Even If the Valuation Method Would Otherwise Be Permissible](#)” (Mar. 17, 2016); and “[Adhering to Disclosed Fee and Valuation Methodologies Is Crucial for Hedge Fund Managers to Avert Enforcement Action](#)” (Jan. 28, 2016).

The SEC charged Visium with failing to ensure that the brokers used by Plaford and Lumiere were dealers in the securities they valued or that those quotes reflected fair value. In addition, despite the pricing policy’s call for at least three dealer marks, of the 308 overrides, 216 were supported by just one quote and 91 were supported by two quotes. See “[GLG Partners Settlement Illustrates SEC Views Regarding Valuation Controls at Hedge Fund Managers](#)” (Jan. 16, 2014).

## Insider Trading

Valvani caused Visium to retain Johnston as a paid consultant. Using his position as vice president of the Generic Pharmaceuticals Association as a pretext, Johnston allegedly deceptively obtained material nonpublic information (MNPI) from a friend at OGD about the

status of pending Abbreviated New Drug Applications (ANDAs) filed by three pharmaceutical companies for a generic version of a drug. Johnston provided that information to Valvani, who then caused the Balanced Fund to trade in certain pharmaceutical companies ahead of the OGD's announcement of its approval of the ANDAs. The SEC claimed that Valvani's trading in those securities generated nearly \$7 million in illicit profits for the Balanced Fund.

See "[HFLR Panel Identifies Best Practices for Avoiding Insider Trading Liability in the Aftermath of Martoma](#)" (Jan. 18, 2018).

In addition, in May 2013, Plaford caused Visium to enter into a consulting agreement with David B. Blaszcak, who allegedly obtained MNPI from a contact at the federal Centers for Medicare and Medicaid Services about a proposed cut in certain Medicare reimbursement rates. Blaszcak passed that information to Plaford, who then caused the Credit Fund and the Balanced Fund to sell short and to purchase put options on certain home healthcare providers that stood to be harmed by the proposed cut. Plaford's trading in those securities allegedly generated illicit profits of \$284,939 for the Credit Fund and Balanced Fund.

For more on Blaszcak and the use of political intelligence, see "[Hedge Fund Manager Deerfield Fined \\$4.7 Million for Failing to Adopt Insider Trading Compliance Policies Tailored to the Firm's Specific Risks](#)" (Sep. 21, 2017); "[SEC Insider Trading Action Highlights Red Flags Hedge Fund Managers Must Heed When Employing Political Intelligence Consultants](#)" (Jun. 8, 2017); and "[How Can Hedge Fund Managers Identify and Mitigate Insider Trading Risks Associated with Gathering and Using Political Intelligence?](#)" (Jul. 11, 2013).

In turn, the illicit profits from Valvani's and Plaford's insider trading allegedly generated nearly \$1.6 million in management and performance fees for Visium.

Visium prohibited its employees from trading on MNPI and required them to alert Visium's chief compliance officer if they thought they had come into possession of MNPI or had questions about whether information constituted MNPI. Visium also provided a "Checklist Resolving Issues Concerning Insider Trading" that required employees to tell consultants not to provide MNPI and to include insider trading prohibitions in consultant agreements. The SEC claimed that "Visium had inadequate measures in place to enforce its policies and to ensure the Checklist was followed, and took inadequate steps to monitor employees' communications with consultants," including those of Valvani and Plaford, who repeatedly failed to comply with Visium's policy.

See "[Hedge Fund Managers Must Ensure That Insider Trading Compliance Policies and Procedures Cover Third-Party Consultants](#)" (Jun. 9, 2016).

## **Ku's Failure to Supervise**

Plaford and Lumiere reported to Ku, who supervised the valuation of all Visium funds. He had ultimate authority to decide what support was required for price overrides and whether to approve overrides. The SEC acknowledged that Plaford and Lumiere never advised Visium's accounting department of how they obtained quotes for price overrides.

Nevertheless, the SEC claimed that Ku missed or ignored three red flags regarding the valuation of Credit Fund assets:

1. Ku received monthly reports detailing all of the Credit Fund's positions, the administrator's prices for those positions and price overrides. Notably, Plaford and Lumiere used overrides,

on average, on one-quarter of the Fund's positions, and the vast majority of those overrides resulted in price increases.

2. Ku received reports showing that in May and June 2012, the price overrides increased the Credit Fund's NAV by 8% and 3%, respectively.
3. On at least three occasions, Ku learned that valuations for certain securities held by the Credit Fund, based on overrides by Plaford and Lumiere, were significantly higher than valuations for the same securities provided to a Visium-advised separately managed account by a different administrator.

The SEC asserted that Ku failed to take any steps to determine whether Plaford or Lumiere may have been engaged in unlawful conduct. When he did ask Plaford about overrides, he allegedly did not verify the independence or reliability of Plaford's sources. Instead, he "simply accepted as true Plaford's false representations that the override quotations were reliable because they were obtained from broker-dealers who made markets in the particular distressed securities." He also allegedly ignored Visium's policy that specified a preference for at least three dealer quotes on overrides and failed to have the valuation committee review and document the overrides.

See "[Hedge Fund Managers Must Guard Against Illicit Cross Trading to Avoid Significant Penalties](#)" (Jan. 14, 2016); and "[Explicit Disclosure of Changes in Hedge Fund Investment Strategy to Investors and Regulators Is Vital to Reduce Risk of Enforcement Action](#)" (Oct. 29, 2015).

See also "[Fund Managers Must Supervise Third-Party Service Providers or Risk Regulatory Action](#)" (Nov. 16, 2017).

In the [press release](#) announcing the settlement, Marc. P. Berger, Director of the SEC's New York Regional Office, said:

Advisory firms must create a culture of zero tolerance when it comes to unlawful conduct, and supervisors at those firms must take reasonable measures necessary to detect and prevent securities law-related violations by their personnel. Here Visium's portfolio managers engaged in illegal asset mismarking and insider trading, and Ku failed to act in the face of red flags that should have exposed the asset mismarking scheme.

## Specific Violations and Sanctions

### Visium Order

The SEC charged that, as a result of the mismarking of securities and insider trading detailed above, Visium violated the following provisions of the Securities Act, Exchange Act and Advisers Act, along with their respective rules:

- *Securities Fraud*: Visium violated the antifraud provisions of [Section 10\(b\)](#) and [Rule 10b-5](#) under the Exchange Act and [Section 17\(a\)](#) of the Securities Act, which prohibit parties from making untrue statements or omissions of material fact; using fraudulent schemes or devices; and engaging in fraudulent or deceptive business practices in connection with the offering or sale of securities.

- *Investment Adviser Fraud*: Visium violated the antifraud provisions of **Section 206** and **Rule 206(4)-8** of the Advisers Act, which prohibit the use of fraudulent or deceptive devices or courses of conduct, engaging in fraudulent or deceptive business practices and the making of material misstatements or omissions of fact with respect to investors in pooled vehicles.
- *Compliance Violations*: Visium violated Advisers Act **Rule 206(4)-7**, which requires an adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of that Act by the adviser and its supervised persons. It also violated **Section 204A** of the Advisers Act, which requires an adviser to adopt and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information by the adviser or any associated persons.
- *False SEC Filings*: Visium violated **Section 207** of the Advisers Act, which makes it unlawful to make material misstatements in SEC filings.

Without admitting or denying the SEC's allegations, Visium has agreed to:

- withdraw its registration as an investment adviser;
- accept a censure;
- cease and desist from violating the referenced provisions of the federal securities laws; and
- pay \$10,231,157, consisting of disgorgement of \$4,755,223, prejudgment interest of \$720,711 and a civil penalty of \$4,755,223.

## **Ku Order**

The SEC charged that Ku failed to reasonably supervise Plaford and Lumiere in violation of Advisers Act **Section 203(e)(6)**, which requires advisers to supervise their employees with a view to preventing violations by those employees of the federal securities laws.

Without admitting or denying the SEC's allegations, Ku has agreed to a one-year suspension from the securities industry and a civil penalty of \$100,000.

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