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OPTIMAL PERFORMANCE

Premium Point Investments LP Form ADV Private Fund Valuation Disclosures Structured Credit and Distressed Asset Funds Convergence Insight #24 May 2018

On May 9, 2018, the Securities and Exchange Commission (“SEC”) filed a complaint against Premium Point Investments LLC (“PPI”) for engaging “in a fraudulent scheme to inflate the value of securities.” “PPI” primarily invested in “structured credit markets, whole mortgage and loan markets and real property markets.”

The valuation inputs for these types of assets typically fall into Level 2 or 3 in the fair value hierarchy and as such, these assets are typically valued by the Adviser, not independent third-party valuation advisers. Therefore, we would have expected “PPI”, and other similar Advisers, to answer 0% to Question 27 in their SEC Form ADV Section 7B: “Private Fund Reporting” which reads *“During your last fiscal year, what percentage of the private fund’s assets (by value) was valued by a person, such as an administrator, that is not your related person.”* Of course, if the Adviser hires independent third-party valuation advisers to prepare a *“Full Valuation Report”* for these assets, and, the values provided by the valuation agent were used by the Adviser or its Administrator to strike the fund’s NAV, they could legitimately answer that 100% of the fund’s assets were valued by a person other than a related party.

The SEC’s complaint states, *“to value the Funds’ securities “PPI” typically used at least one third-party vendor and at least one broker-dealer that Premium Point traders selected to provide month-end price quotes. Premium Point used the price quotes it received from any such vendor and broker dealer to calculate the Funds’ NAVs and report them to investors.”* “PPIs” related parties created their own marks for these assets yet disclosed in its Form ADV, dating back to 2014, that 100% of their private funds assets were valued by an “unrelated person.” Was this a mistake, misinterpretation or something more nefarious? The courts will decide, yet investors would have been well served to have understood “PPIs” answer to this question.

Convergence reviewed the ADV filings of 2 Advisers who are large players in structured credit and distress credit funds. Both Advisers’ ADV’s indicate that 0% of their fund assets are valued by an unrelated party, which is what we would generally expect. When we increased the scope of our review, we discovered that answers to this question varies across similar Advisers. 42% of Advisers to CMBS/ABS funds disclose 0% independent valuation and 51% disclose 100% independent valuation, with only 8% disclosing between 0% and less than 100%. In Distress Debt, 35% answer 0%, 28% answer between 0% and less than 100% and 37% answer 100%.

Distribution of % of Assets Valued Externally							
Investment Strategy	0%	>0-25%	26%-50%	51%-75%	76%-99%	100%	Total
MBS-ABS	42%	3%	0%	1%	3%	51%	100%
Distressed	35%	3%	1%	5%	19%	37%	100%

While it is possible that Advisers to CMBS/ABS and Distress Debt funds are relying on unrelated persons to value these securities, i.e., Independent Valuation Advisers, it is more common that Advisers obtain multiple external inputs (Broker Quotes) and apply their judgment on which quotes to use to establish the final valuation. So, in these cases, valuation is not independent, and they should answer 0% to Question 27 in their ADV.

Companies providing services to Advisers to structured credit and distress funds would be well served to examine the ADVs of these clients to evaluate potential inconsistencies, particularly Fund Auditors, Fund Administrators and Prime Brokers, where their services, in whole or in part, touch asset valuation. At the minimum, you may be able to help your clients, who may be misinterpreting this important Form ADV question.

Compliance Officers reading this insight need not be reminded of the **WARNING** that appears on the top of your Form ADV: ***Complete this form truthfully. False statements or omissions may result in denial of your application, revocation of your registration, or criminal prosecution. You must keep this form updated by filing periodic amendments.***

For more information about how Convergence's proprietary analytics can detect "anomalies" in historical Form ADV filings, please contact George Gainer or John Phinney at 203-956-4824.

ⁱ FULL VALUATION REPORT-In connection with the preparation of a typical full valuation report, the valuation firm performs its own valuation by selecting the methodology/methodologies, the appropriate valuation assumptions based on direct discussions with investee company management, and other procedures that they deem appropriate. The concluded value may be a point estimate or a range of values. This opinion is typically considered an independent valuation. The popularity of these reports is hampered by the cost and time to-complete associated with them. These reports have a higher rate of acceptance by audit firms; however, if the range of values is too large, acceptance may be lessened.