

SEC Targets Fund Auditor in Latest Battle Over Valuation Practices

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Going into 2020, we expected scrutiny over valuation methods to be one of the [top regulatory risks](#) for private funds. With ongoing economic uncertainty applying pressure, the SEC will continue to focus on valuation issues surrounding portfolio investments. Fund audit firms are not immune to regulatory scrutiny involving their professional obligations with respect to fund valuation issues.

A recent pair of SEC charges shows this trend in action. In December 2019, the SEC [filed a complaint](#) against a private fund manager, SBB Research Group, LLC, and two of its executives for a multi-year fraud involving the overvaluation of structured notes. The charged executives told prospective investors they used “fair value” in recording investments, but allegedly used their own novel valuation method that inflated investment value, causing SBB to overstate historical performance and overcharge investor fees. The complaint also alleged that SBB attempted to cover up the valuation issues from their investors and auditor.

Then, on February 26, 2020, the SEC issued a settled [order](#) instituting administrative proceedings against SBB's auditor, RSM US LLP, for failing to catch SBB's valuation fraud over years of audits. The SEC found that RSM's system of quality control in staffing featured deficiencies that led to issues with audits conducted in 2013-2015. Namely, SBB retained two valuation specialists who were unfamiliar with structured note valuations. The specialists misunderstood SBB's valuation technique, which according to the SEC order, jeopardized "the audit team's ability to assess the reasonableness of SBB's valuation assumptions, possible inappropriate management bias, the reliability of SBB's inputs, and the appropriateness of SBB's valuation methodology." In 2016, after the SEC's pending enforcement investigation and an SEC exam deficiency letter issued to SBB citing flaws in its valuation practices came to light, RSM concluded that a restatement of prior financial statements was unnecessary, despite receiving third-party valuations that were different from SBB's valuations by amounts that exceeded RSM's materiality thresholds. RSM later resigned as SBB's auditor and recalled its audit reports from 2013 through 2017, citing inconsistencies between what SBB told RSM during prior audits and what it revealed to the SEC in the course of the enforcement investigation.

The SEC found that RSM violated professional auditing standards and engaged in improper professional conduct under the Securities Exchange Act and the Commission's Rules of Practice. The SEC imposed a censure and ordered compliance with a long and detailed list of undertakings, including submission of a policy report and validation plan to SEC staff describing RSM's review, testing, and assessment of, among other things, quality controls surrounding staffing and procedures used to determine when a valuation specialist is necessary and how he or she is vetted.

Together, these SEC actions suggest a continued regulatory focus on valuation issues, targeting not only those who are directly responsible, but also auditors and other service providers who can be viewed as "enabling" such overvaluations. The RSM order also increases pressure on auditors to treat valuation practices with greater scrutiny, implementing policies that ensure the appointment of qualified specialists to evaluate valuation procedures when necessary.

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