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SEC Valuation Enforcement Cases and Valuation Best Practices

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Shaun is a partner with the Forensics & Valuation service line and has more than 15 years of experience, specializing in valuing businesses, intangible assets, and other complex financial instruments. His experience covers valuations for financial reporting, tax reporting, mergers and acquisitions, shareholder buyouts, corporate planning, and various civil and commercial litigation matters. Shaun has conducted valuations of securities and intangible assets of public and private corporations for share-based compensation (under IRC 409a and ASC 718), impairment testing (ASC 350/IAS 36), purchase price allocations (ASC 805/IFRS 3), derivative reporting (ASC 815), and other purposes requiring fair value measurements under ASC 820/IFRS 13. Prior to joining Forvis Mazars, Shaun was a managing director in a large national accounting firm's financial advisory services group.

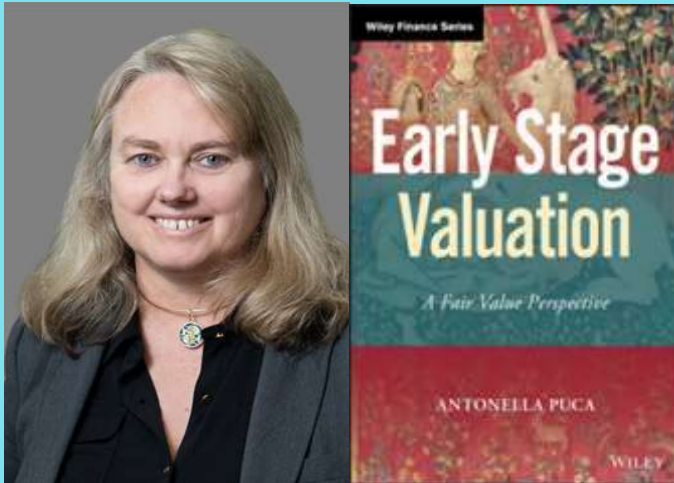
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He is a summa cum laude graduate of Seton Hall University, South Orange, New Jersey, with a B.S. degree in finance and economics and an M.B.A. degree in accounting.

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Antonella Puca is a Partner of BlueVal in New York. Antonella specializes in the valuation of interests in private equity and venture-backed companies for financial and tax reporting, M&A transactions, buy-sell agreements, gift/estate planning, and litigation purposes. Prior to joining BlueVal, Antonella held positions at various valuation advisory firms, KPMG & EY in San Francisco and in New York. With more than 20 years of experience in the alternative investment industry, Antonella is the author of *Early Stage Valuation* (Wiley: 2020) and a frequent speaker on the valuation of VC- and PE-backed companies. Antonella is qualified as an expert witness in the State of California.

Antonella is a member of the CFA Institute and the AICPA. She holds the CFA charter and is licensed as a CPA in California and in New York. Antonella served as a member of Alternative Investment Management Association's (AIMA) research committee, as a director and treasurer of the Board of the CFA Society of New York, as a judge on the CFA Institute Research Challenge, and as a director and consultant on industry standards, practice analysis and curriculum review at CFA Institute. Antonella served on the Business Valuation Committee and is currently serving on the ABV Credentialing Committee of the AICPA. She is a consultant on the CFA exam development team. She received the 2021 Business Valuation Volunteer of the Year Award of the AICPA and is included in Forbes 2025 America's Top CPAs for Valuation.

Antonella earned a Master Degree in Economics, with honors, from the University of Naples Federico II, Italy and a Master in Law Studies in Taxation from the NYU School of Law. She has been a research fellow at the Hebrew University of Jerusalem.

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Any positions presented in this session are those of the panelists.

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Additionally, all positions do not represent the official position of their respective firms.

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Agenda

- Overview of U.S. SEC Guidance and Enforcement in Valuation
- Case Study 1: SEC v. United Parcel Service, Inc. (Filed: November 22, 2024) - Failure to Impair Goodwill
- Case Study 2: SEC v. Infinity Q Capital Management, LLC (Filed: June 16, 2023) – Model and Pricing Manipulation in Private Fund
- Case Study 3: SEC v. Sciens Investment Management, LLC & Sciens Diversified Managers, LLC (Filed: May 24, 2023) - Deficiency in Policies and Procedures and their Implementation
- Case Study 4: SEC v. ZM Quant Investment Ltd and Others (Filed October 9, 2024)

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SEC Guidance and Enforcement in Valuation (2010–2025)

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Introduction

The U.S. Securities and Exchange Commission (**SEC**) plays a critical role in **overseeing valuation practices** of investment companies and investment advisers to ensure fair and transparent financial reporting. Accurate valuation of assets, especially illiquid or complex instruments, is essential for investor protection and market integrity. The SEC enforces valuation standards through guidance, regulatory oversight, and enforcement actions. Under the Investment Company Act of 1940, funds must use **market values** when available and **determine fair value** in good faith when they are not, directly impacting NAV calculations. The SEC also monitors valuation inputs, assumptions, and methodologies used by public companies and funds, and holds both management and valuation professionals accountable when practices fall short of regulatory expectations.

Source of Regulation:

- Investment Company Act of 1940
- Investment Advisers Act of 1940
- Securities Act of 1933
- Securities Exchange Act of 1934

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SEC 2025 Examination Priorities

- Investment Advisers:
 - examination of valuation policies and procedures as a core are of the Investment Adviser's compliance programs. Effect of valuation on NAV and accuracy of fee calculations.
 - For clients that invest in illiquid or hard-to-value assets, examinations may have a heightened focus on valuation.
 - Advisers to private funds: focus on funds that hold more leverage and hard-to-value assets
- Investment Companies:
 - Oversight of service providers
- General: valuation of crypto assets

Stefanik's Letter to SEC Chairman (June 2025)

Occasion: Harvard's bond issuance

Letter highlights risks associated with illiquid and leveraged asset holdings, including private equity, venture capital and real estate in university endowment's portfolios.

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Year	Company	Category	Summary of Issue
2010	GLG Partners	Overvaluation & Internal Control Failures	Overvalued a 25% stake in a coal mining company by failing to escalate valuation concerns to the pricing committee. Lacked consistent monthly review of Level 3 assets, undermining fair value determination and violating internal pricing policies.
2010	Brantley Capital Corp.	Fraudulent Valuation & NAV Inflation	Robert P. Pinkas overstated the valuations of two major portfolio companies, which comprised over half of Brantley Capital's investment holdings. He provided misleading information in public filings and failed to disclose material facts to the board, auditors, and investors. These actions distorted the company's financial statements and misled the market about the true value of its assets.
2011	Morgan Asset Management, Inc.	Fraudulent Valuation & NAV Inflation	The portfolio manager manipulated fund valuations by submitting undocumented "price adjustments" that artificially inflated the value of subprime mortgage-backed securities, violating the Funds' valuation policies. Fund Accounting accepted these adjustments without verification. Additionally, the portfolio manager pressured a broker-dealer to alter or withhold price confirmations, undermining independent valuation checks and preventing necessary markdowns, which misled investors about fund performance.
2012	Yorkville Advisors	Fraudulent Valuation	Overvalued fund assets and exaggerated returns to hide losses and collect excessive fees. Ignored internal valuation policies, withheld negative information from auditors, and misled investors about asset liquidity and third-party validation.
2012	UBS Global Asset Management (Americas) Inc.	Misuse of Broker Quotes	UBSGAM ignored the funds' valuation procedures requiring the use of transaction prices when discrepancies of 3% or more arose. Instead, they relied on inflated broker-dealer and third-party quotes, which lacked active market pricing and were initially valued at prices often over 100% higher than their actual purchase prices. This caused the funds' net asset values (NAVs) to be significantly overstated for several days.

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Year	Company	Category	Summary of Issue
2012	KCAP Financial, Inc.	Overvaluation & Internal Control Failures	KCAP Financial overstated the value of its portfolio by ignoring market data. For debt securities, it used an internal valuation method that didn't reflect actual market exit prices, disregarding observable trades showing much lower values. For its two largest CLO investments, KCAP valued them at cost instead of applying market-based discounted cash flow models, despite claiming otherwise publicly. This led to significant overvaluation of both asset types.
2013	Regions Morgan Keegan Funds	Director Oversight Failure in Valuation	Fund directors failed to oversee fair value determinations for subprime mortgage-backed securities, delegating responsibilities without adequate guidance or monitoring. Over 60% of NAVs were based on poorly supervised fair valuations, leading to overstated fund values.
2013	Oppenheimer Alternative Investment Management, LLC	Fraudulent Valuation & NAV Inflation	The fund's portfolio manager improperly changed the valuation method for their largest holding, using a "par value" based on the Romanian government's issuance price instead of the underlying manager's valuation. The portfolio manager did not disclose this deviation to investors or compliance, resulting in misleading marketing materials and reports that falsely claimed valuations were based on underlying managers' estimates. This led to materially overstated performance metrics, including an inflated internal rate of return (IRR).
2013	RMK Funds	Fraudulent Valuation & NAV Inflation	The RMK Funds faced significant valuation problems stemming from inadequate methodologies and poor oversight. Portfolios required fair valuation due to illiquid, complex structured products. However, instead of applying reasonable valuation techniques such as pricing models or cash flow analysis, Fund Accounting typically used the original purchase price and left values unchanged unless there was a substantial deviation confirmed by a broker quote or sale. Price adjustments were frequently made by the Portfolio Manager without explanation and were accepted without review or documentation. Broker quotes used for validation were often non-binding, outdated, or ignored when they conflicted with internal valuations.

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Year	Company	Category	Summary of Issue
2016	Calvert Investment Management, Inc.	Fraudulent Valuation & NAV Inflation	Calvert inaccurately valued complex, illiquid Toll Road Bonds held by multiple Calvert-managed funds. Rather than determining fair value correctly, Calvert depended largely on a defective third-party analytical tool that did not adequately consider the bonds' future cash flows or incorporate relevant market information such as actual trade prices and valuations from other investors. Consequently, the values assigned to these bonds were significantly overstated.
2016	Pacific Investment Management Company LLC	Overvaluation & Internal Control Failures	PIMCO employed a strategy to boost BOND's early performance by purchasing small, "odd lot" positions of non-agency mortgage-backed securities (NAMBS) that traded at discounts to larger "round lot" positions. However, PIMCO valued these odd lot positions using pricing marks meant for larger institutional round lots, which were generally higher. This resulted in overstating the fair value of these securities and consequently inflating BOND's net asset value (NAV) during the relevant period.
2017	Covenant Financial Services, LLC	Inaccurate Fair Value Measurement	Covenant improperly valued municipal bonds in five private funds by relying almost exclusively on a third-party Pricing Service using unobservable inputs, despite available market data indicating lower fair values. This violated GAAP and Covenant's own valuation policy, which required maximizing observable inputs like broker quotes and actual trades.
2018	Fifth Street Management LLC	Valuation Review & Expense Misallocation	Failed to conduct adequate reviews of valuation models, leading to the overvaluation of two portfolio companies and misstated net income. Also misallocated over \$1.3M in expenses to clients. Resulted in overvalued public share issuance.

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Year	Company	Category	Summary of Issue
2018	Visium Asset Management	Inaccurate Fair Value Measurement	The firm manipulated valuations by using sham broker quotes to inflate prices, overriding reliable pricing sources, and misclassifying illiquid securities as more liquid under ASC Topic 820. These actions resulted in inaccurate asset values and misleading financial reporting.
2019	SBB Research Group	Inaccurate Fair Value Measurement	Inflated fund values via non-GAAP internal model; overcharged \$1.4M in fees.
2019	West Mountain LLC	Inaccurate Fair Value Measurement	Overvalued private company assets using unrealistic assumptions; ignored independent valuations by a third party; SEC alleged fraud.
2019	Deer Park Road Management	Misuse of Broker Quotes	Undervalued MBS by submitting inaccurate data to pricing vendors; \$5M penalty for failure to use observable inputs.
2021	Sequential Brands Group, Inc.	Goodwill Impairment Failure	Failed to timely impair \$304M of goodwill despite clear internal evidence and declining stock prices. Used a flawed qualitative analysis that omitted negative indicators, inflating income and misstating financials for nearly a year.
2023	Sciens Diversified Managers	Inadequate Valuation Policies	Failed to implement adequate valuation policies for illiquid private investments. Provided minimal guidance on valuing Level 3 assets under GAAP, leading to risks of incorrect fee calculations and inaccurate performance reporting.
2023	Infinity Q Capital Management	Fraudulent Valuation & NAV Inflation	Engaged in a multi-year mismarking scheme that fraudulently inflated the NAVs of a mutual fund and private fund from 2017 to 2021. Mispricing was led by the CIO, leading to materially false valuations and excess fees charged to investors.
2024	UPS	Goodwill Impairment Failure	Failed to impair \$1.4B Freight unit goodwill despite internal sale estimates of \$350M-\$650M; withheld key data from consultant; \$45M SEC penalty.

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Case 1: SEC v. UPS (Nov 2024)

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Case 1: UPS – Failure to Impair Goodwill

Case Name:

SEC v. United Parcel Service, Inc. (Filed: November 22, 2024)

Parties Involved:

Respondent: United Parcel Service, Inc. (UPS)

Consultant: External valuation firm (unnamed)

Individuals: Senior UPS accountant, corporate strategy/M&A teams

Business Context:

The case involves **UPS Freight**, a struggling business unit that UPS internally valued at **\$350M–\$650M** in 2019, compared to a **carrying value of \$1.4B**. Despite this significant gap, UPS failed to recognize a goodwill impairment in both 2019 and 2020. It instead relied on an external consultant's valuation of **\$2B**, based on flawed assumptions and incomplete data.

In 2020, UPS began negotiating a sale of Freight and signed a term sheet at **\$800M** (later adjusted to **\$650M** net). A goodwill write-down was only recorded in **Q4 2020**, following the sale agreement. The SEC found this delay misleading and non-compliant with GAAP.

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Case 1: Valuation Issues (1 of 2)

1. Ignored Internal Evidence of Impairment

- In **2019 internal M&A analysis** estimated UPS Freight's fair value at **\$350M–\$650M**, far below its **\$1.4B carrying value**.
- Under **GAAP (ASC 350/820)**, this gap indicated clear goodwill impairment, but **UPS chose not to write down** the asset.
- The internal estimate reflected market-based assumptions—**the same criteria GAAP requires**.

2. Flawed Consultant Valuation (~\$2B)

- UPS relied on a valuation consultant that used **overly optimistic assumptions**, including:
 - Inflated profit margins due to cost-sharing with other UPS units
 - Omission of standalone operational costs (HR, legal, IT, pensions)
 - Unrealistic revenue and profit growth projections
- Used **non-comparable peer companies** (e.g., non-unionized firms with higher multiples) in the **GPC method**. UPS was responsible for confirming the suitability of the peer companies list.

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Case 1: Valuation Issues (2 of 2)

3. Omitted Critical Information from the Consultant

- UPS failed to inform the consultant about:
 - The **internal fair value estimate (\$350M–\$650M)**
 - Ongoing **sale negotiations in 2020** at ~\$800M
 - A **signed term sheet** for \$800M before Q3 2020 filing
- These omissions led the consultant to **overvalue Freight at ~\$2B**, both in 2019 and 2020.

4. Misleading Impairment Conclusions in 2020

- UPS claimed “**no indicators of impairment**” and “no events or change in circumstances” that would indicate an impairment in its Q3 2020 10-Q—**filed one day before Board approved sale**.
- Under GAAP, the **signed term sheet was a “Type 1 Subsequent Event”** requiring recognition of fair value decline.
- Still, UPS **relied on flawed consultant data** and failed to impair goodwill until public sale announcement in **January 2021**.

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Case 1: SEC Findings & Penalties (1 of 2)

Securities Act of 1933

- **Section 17(a)(2)** – Prohibits obtaining money or property through untrue statements of material fact or omissions of material facts in the offer or sale of securities.
- **Section 17(a)(3)** – Prohibits engaging in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
 - ◆ *UPS made materially misleading statements and omissions about the fair value of the Freight unit and failed to disclose accurate goodwill impairments.*

Securities Exchange Act of 1934

- **Section 13(a)** – Requires issuers to file accurate periodic reports.
- **Rules 13a-1, 13a-11, and 13a-13** – Implement Section 13(a), covering Form 10-Ks, 8-Ks, and 10-Qs respectively.
 - ◆ *UPS's Forms 10-K and 10-Q falsely stated that no indicators of impairment existed, despite internal evidence to the contrary.*
- **Rule 12b-20** – Requires additional material information to make statements not misleading.
 - ◆ *UPS omitted key facts, including sale negotiations and internal fair value estimates.*

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Case 1: SEC Findings & Penalties (2 of 2)

- **Section 13(b)(2)(A)** – Requires books and records to accurately reflect transactions.
- **Section 13(b)(2)(B)** – Requires internal accounting controls to ensure reliability of financial reporting.
 - ⚡ *UPS failed to maintain sufficient controls to ensure goodwill testing and reporting were GAAP-compliant.*
- ✓ **GAAP:**
 - **ASC 350** – Requires entities to test **goodwill for impairment** annually or when **triggering events** occur.
 - **ASC 820** – Requires that fair value be based on **assumptions market participants would use**, not management's internal projections.
 - **ASC 855** – Requires companies to **evaluate events after the balance sheet date** but before financial statements are issued
- **Rule 13a-15** – Requires issuers to maintain effective disclosure controls and procedures.
 - ⚡ *UPS lacked proper oversight over impairment analysis and the information provided to valuation consultants.*

Penalties Imposed

- **Cease-and-Desist Order**
 - UPS agreed to stop violating securities laws and financial reporting standards.
- **Pay a civil money penalty of \$45 million**
- **Remedial training and retention of independence compliance consultant**

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Case 1: Key Lessons

- ✓ **Internal Fair Value Assessments Are Relevant (ASC 350):**
UPS's internal M&A analysis (valuing Freight at \$350M–\$650M) was relevant under GAAP and should have triggered a goodwill impairment. Ignoring it violated ASC 350 requirements for using the best available information.
- ✓ **Consultants Don't Replace Management Judgment (ASC 820):**
Engaging a valuation consultant does not relieve management of responsibility. UPS failed to provide key facts (e.g., expected sale price, internal forecasts adjusted for standalone costs, insights on the selection of peer companies) necessary for a fair value estimate under ASC 820.
- ✓ **Valuation and Disclosures Must Reflect Material Events (Exchange Act & ASC 855):**
Despite active negotiations to sell Freight for ~\$800M, UPS stated there were "no indicators of impairment" in Q3 2020. This contradicted known facts and violated SEC disclosure rules and GAAP subsequent event standards (ASC 855).
- ✓ **Control Failures Led to Misstatements (Exchange Act §13(b)(2)):**
UPS lacked adequate internal controls to ensure reliable financial reporting. As a result, it overstated Freight's value and misled investors, violating rules on books, records, and internal controls over financial reporting.

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Case 1: Takeaways for Valuation Professionals

- ✓ Exercise professional skepticism
- ✓ Consider if your management questionnaires are sufficient:
 - ✓ Does management prepare any internal valuation estimates that we should be aware of?
 - ✓ Has the company received any LOIs, and/or is the company undergoing any negotiations to sell all or part of the business/asset?
- ✓ Testing of PFI and question assumptions
 - ✓ Use of benchmarking
 - ✓ Review of corporate allocations
- ✓ Evaluation of management within context of discount rate development
- ✓ Comps require close evaluations, consider nuance (i.e., unions) that may impact multiples

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Case 2: SEC v. Infinity Q Capital Management (June 2023)

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Case 2: Infinity Q Capital Management – Fraudulent Valuation

Case Name:

SEC v. Infinity Q Capital Management, LLC (Filed: June 16, 2023)

Parties Involved:

- Respondent:** Infinity Q Capital Management, LLC
- Consultant:** Pricing Service (unnamed)
- Individuals:** Founder & CIO, CCO & Portfolio Manager

Business Context:

The case centers on **Infinity Q Capital Management**, a New York-based investment adviser that managed approximately \$1.8 billion in assets across a mutual fund (Infinity Q Diversified Alpha Fund) and a private fund (Infinity Q Volatility Alpha Fund). From 2017 to early 2021, the firm promoted itself as offering sophisticated, market-neutral strategies through custom derivatives, including complex variance and correlation swaps.

Infinity Q used a **third-party pricing service** to value these OTC derivatives, but in reality, CIO James Velissaris **manipulated** the underlying models and **inputs** to inflate asset values. By March 2020, amid COVID-driven market volatility, the firm overstated valuations by up to **42% in the mutual fund** and **137% in the private fund**, creating a more than **\$1 billion overvaluation**.

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Case 2: Valuation Issues (1 of 2)

1. Deliberate Mismarking via Custom Code Manipulation (~\$1B+ Inflated AUM)

- The CIO edited underlying valuation code in a third-party pricing platform, falsely presenting prices as independent.
- Modifications included:
 - Widening or removing corridor bounds in variance swaps
 - Replacing logical operators (e.g., “AND” → “OR”) to artificially boost payout calculations
 - Setting mathematically impossible inputs (e.g., annualization factors > 365 days)

2. Intentional Input Tampering and Model Abuse

- Altered key valuation parameters:
 - **Volatility surfaces** cherry-picked from up to 90 snapshots to favor long or short positions
 - Changed **effective dates**, **notional values**, and **strike prices** post-trade to generate favorable P&L
- Chose **improper models** (e.g., using “vanilla” models for corridor swaps) to bypass corridor logic entirely
- Ignored Pricing Service guidance directing use of more accurate, uneditable models introduced in 2019

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Case 2: Valuation Issues (2 of 2)

3. Fabrication of Supporting Evidence & Auditor Deception

- Provided **forged term sheets and confirmation documents** to external auditors to justify valuations
- Presented manipulated prices as “independently determined,” despite full control over valuation mechanics
- Violated internal policies requiring use of consistent prices across funds and maintenance of documentation for any manual pricing adjustments

4. Suppressed Contradictory Internal & Market Signals

- Ignored valuation discrepancies >\$20M between Infinity Q’s internal marks and counterparty valuations
- Continued using inflated marks despite:
 - Counterparties issuing margin calls based on lower valuations
 - Internal compliance warnings and risk reviews highlighting inconsistencies
- Reported **mathematically impossible valuations** (e.g., negative volatility), which GAAP would never allow under ASC 820

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Case 2: SEC Findings & Penalties (1 of 2)

Securities Act of 1933

Section 17(a) – Prohibits fraudulent misstatements or omissions in the offer/sale of securities.

◆ *Infinity Q disseminated inflated NAVs and misleading pricing assumptions in fund materials.*

Exchange Act of 1934

Section 10(b) & Rule 10b-5 – Prohibits manipulation and deception in securities transactions.

◆ *Velissaris engineered a pricing scheme by altering model inputs and outputs in a supposedly independent platform.*

Investment Company Act of 1940

Rule 22c-1 – Requires funds to strike daily NAVs based on fair value.

◆ *Mutual fund NAVs were based on manipulated valuations, including mathematically impossible swap prices.*

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Case 2: SEC Findings & Penalties (2 of 2)

Compliance with US GAAP Violated

ASC 820 – Requires fair value to reflect an **exit price** based on observable inputs and market participant assumptions.

◆ *Infinity Q manipulated inputs to create unobservable, non-market-based valuations. It Disregarded counterparty quotes and observable market data and Reported mathematically impossible values.*

Penalties Imposed

CIO James Velissaris → Criminal conviction: sentenced to 15 years imprisonment

Infinity Q → Facing civil penalties, disgorgement of ill-gotten gains, and oversight by an independent monitor.

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Case 2: Key Lessons

✓ Reinforce the Independence of Third-Party Valuations

Third-party pricing services must operate independently and be free from influence by portfolio managers or traders. Internal personnel should have **read-only access** to model outputs, not the ability to modify model assumptions, valuation inputs, or underlying code.

✓ Strengthen Internal Controls and Governance Over Valuation

Establish a functionally independent valuation committee that operates separately from the portfolio management team. The committee must have clearly documented valuation policies, escalation protocols, and periodic oversight from the board or audit committee.

✓ Enforce Rigorous Documentation and Model Governance

Every valuation input, override, or model selection must be supported by detailed, time-stamped records. It is important to maintain model validation reports, audit trails of changes, and rationale memos for any manual adjustments. Additionally, it is essential to ensure that all documentation aligns with ASC 820's emphasis on market-based assumptions and observable inputs.

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Case 2: Takeaways for Valuation Professionals

- ✓ Exercise professional skepticism
- ✓ Audit review responsibilities
 - ✓ Review of acceptable methodology for subject asset/security
 - ✓ Perform corroborative procedures related to inputs/assumptions, reviewing documentation/sources
 - ✓ Exercise caution with third-party pricing, resources
 - ✓ Mathematical proofing

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Case 3: SEC v. Sciens Investment Management (May 2023)

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Case 3: Sciens Investment Management – Inadequate Valuation Policies

Case Name:

SEC v. Sciens Investment Management, LLC & Sciens Diversified Managers, LLC (Filed: May 24, 2023)

Parties Involved:

- Respondent:** Sciens Investment Management, LLC (SIM), Sciens Diversified Managers, LLC (SDM)
- Fund:** Sciens Special Situations Master Fund Ltd. (SSSMF)
- Individuals:** CEO of both SIM and SDM; Portfolio Manager of SSSMF
- Business Context:**

The case centers on **Sciens Investment Management**, a New York-based investment adviser managing **approximately \$235 million** across a series of **private equity-style funds**. Its flagship vehicle, the **Sciens Special Situations Master Fund Ltd. (SSSMF)**, focused on **illiquid, hard-to-value assets**, including private loans, distressed debt, and direct lending deals—classified as **Level 3 investments** under accounting standards.

From at least **2016 to 2021**, Sciens charged **quarterly management fees based on Net Asset Value (NAV)**, which the firm calculated internally using its own valuation practices. However, the SEC found that Sciens **failed to establish any meaningful valuation methodology** for its Level 3 assets.

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Case 3: Valuation Issues (1 of 2)

1. Absence of Structured Valuation Framework for Level 3 Assets

Sciens failed to implement a formal valuation methodology despite managing highly illiquid, Level 3 private investments.

Key gaps included:

- No defined models (e.g., DCF, market comps) or calibration processes
- No quantitative approach for unobservable inputs as required by ASC 820
- No evidence of fair value cross-checks or validation against market participant data

2. Procedural Deficiencies and GAAP Non-Compliance

Policies merely echoed ASC 820 language without operational execution.

Deficiencies included:

- No procedures for assessing observable vs. unobservable inputs
- No internal documentation of valuation assumptions or sensitivity analysis
- No internal valuation committee or independent price challenge process

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Case 3: Valuation Issues (2 of 2)

3. Auditor Red Flags and Material NAV Misstatements Ignored

Sciens received multiple qualified audit opinions due to unverifiable asset values—warnings went unaddressed.

Consequences:

- 2016 valuation write-down of ~\$32.9 million (one asset)
- Retroactive NAV adjustments led to multi-year fee clawbacks (2016–2019)
- One audit firm withdrew its opinion entirely, signaling severe breakdown in valuation governance

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Case 3: SEC Findings & Penalties

Investment Advisers Act of 1940

Section 206(4) & Rule 206(4)-7 (Compliance Rule) – Requires advisers to adopt and implement written policies to prevent violations of federal securities laws.

- ◆ **Sciens failed to implement adequate valuation procedures**, particularly for hard-to-value Level 3 assets. No operational framework to meet ASC 820 standards
- ◆ **No clear methodologies, oversight, or calibration protocols** despite significant reliance on self-valued assets for fee calculation.
- ◆ **Policies lacked mechanisms to manage conflicts of interest** in adviser-led valuation of fund holdings.

Civil Penalties & Sanctions

- **Cease-and-Desist Order** : SDM and SIM were ordered to cease and desist from future violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 (Compliance Rule). SDM must retain an **Independent Consultant (IC)**, subject to SEC approval.
- **Censure**: Both firms were publicly censured for their misconduct.
- **Monetary Penalty**: A **\$275,000 civil penalty** was imposed on SDM and SIM.

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Case 3: Key Lessons

✓ **Establish Practical, Not Merely Theoretical, Valuation Policies**

Valuation procedures must go beyond merely copying the language of ASC 820. Firms should develop actionable, fund-specific policies that clearly define how valuation models are selected and calibrated, establish a hierarchy for inputs, distinguishing between observable and unobservable data, and set regular internal review timelines along with clear escalation protocols for complex or uncertain valuations.

✓ **Develop Robust Methodologies for Level 3 Asset Valuation**

Hard-to-value investments require more than subjective judgment, they demand a structured and transparent approach. Firms must use clear valuation models such as discounted cash flow or market comparables, thoroughly document all assumptions and data sources, and regularly recalibrate these models to reflect evolving market conditions.

✓ **Require Independent Review for Level 3 Assets**

For illiquid holdings, firms should regularly engage independent third-party valuation firms to provide objective assessments. Any overrides of suggested prices must go through a dual-approval process to ensure accountability and reduce the risk of bias. Additionally, firms must maintain comprehensive audit trails that clearly document the rationale for valuations and any subsequent revisions.

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Case 3: Takeaways for Valuation Professionals

- ✓ Exercise professional skepticism
- ✓ Audit review – qualified opinions and resignation may be necessary, mitigate risk to stakeholders, including the audit firm
- ✓ Documentation
- ✓ Theory vs. execution

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Case 4: SEC v. ZM Quant Investment Ltd and Others (Oct 2024)

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Case 4: ZM Quant Investments Ltd – Market Manipulation

Case Name:

SEC v. ZM Quant Investments Ltd and Others (Filed: October 9, 2024)

Parties Involved:

- Respondent:** ZM Quant Investmetns, Ltd (“ZM Quant”) and Others
- Token:** NexFund AI and Saitama, ERC-20 standard tokens on the Ethereum blockchain.
- Individuals:** CEO of both SIM and SDM; Portfolio Manager of SSSMF
- Business Context:**

The case centers on **ZM Quant Investments Ltd**, a company registered in the BVI that operates both inside and outside the United States. ZM Quant offers various services for crypto asset projects, including investment and consulting services, and “market making”. ZM Quant purports to have offices in Hong Kong, Singapore, London and Seoul.

Starting in **May 2024**, ZM Quant facilitated trading of NexFund AI and Saitama on crypto exchanges. The SEC found that ZM Quant **created artificial trades** in its clients’ crypto assets to artificially inflate their price and trading volume, falsely suggesting that there were multiple parties interested in the tokens. ZM Quant received a “gas fee” on the trades it generated on various crypto trading platforms.

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Case 4: Valuation Issues

1. Pricing Manipulation

ZM Quant's trading activity had effects on token prices, resulting in prices that did not reflect arms' length transactions.

2. Volatility and Volume Manipulation

Volatility and Volume manipulation affect DLOM analysis

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Case 4: SEC Claim & Penalties

Securities Act of 1933:

Section 17(a)(1) and (3) – Fraud in the offer or sale of securities

⚡ ZM Quant **employed devices, schemes, or artifices to defraud** and engaged in transactions, practices or course of business **which operated as a fraud or deceit** upon any persons, including purchasers or sellers of securities.

Securities Exchange Act of 1934:

Section 10(b) and Rules 10b-5(a) and (c) – Fraud in the offer or sale of securities

Section 9(a)(2) – Market Manipulation

Penalties & Sanctions

- Case is in progress.

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Case 4: Key Lessons

- ✓ **The valuation/pricing of crypto assets is a growing area of practice for valuation professionals and requires a specialized expertise.**

It is important for valuation analysts in this area to gain an understanding of the technical feature of the subject crypto asset, its trading platform, trading parties involved, underlying business, fiat currency conversion process, and be alert for any potential for market manipulation.

- ✓ **The regulatory framework for crypto assets is in the early stages of its development**

As a profession, we need to continue to monitor regulatory developments to make sure we are aware of any related valuation guidance in this area and any practices that may affect our work.

- ✓ **Data quality and reliability is a critical area of focus in crypto asset valuation.**

The analyst should consider the source and reliability of pricing information, and the potential for market manipulation. Trading volume and volatility are important factors in the assessment of discounts for lack of marketability for crypto assets in the presence of vesting schedules and based on the size of the position to be valued.

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Case 4: Takeaways for Valuation Professionals

- ✓ Exercise professional skepticism
- ✓ Exercise reasonable caution in “new” industries but lean on industry experts – are we scared of this industry?
- ✓ Support and document assumptions

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Final Thoughts

- ✓ SEC enforcement is increasingly focused on valuation rigor
- ✓ Stay current with evolving standards
- ✓ Think critically, document thoroughly
- ✓ Exercise professional skepticism in all engagements

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Appendix – Management Bias (Auditing Guidance)

Indicators of Possible Management Bias .32 The auditor should evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor should evaluate the implications for the audit. When there is intention to mislead, management bias is fraudulent in nature. (Ref: par. .A133–.A136)

- Matters that the auditor may consider in obtaining an understanding of how management identifies and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so, how, management does the following:
- Pays particular attention to selecting or applying the methods, assumptions, and data used in making accounting estimates
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors
- Identifies financial or other incentives that may be a motivation for bias
- Monitors the need for changes in the methods, significant assumptions, or the data used in making accounting estimates
- Establishes appropriate oversight and review of models used in making accounting estimates Requires documentation of the rationale for or an independent review of significant judgments made in making accounting estimates

Indicators of Management Bias (Ref: par. .22b, .23b, and .24b) .A96 When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained, indicating that the method, assumptions, and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case, the assumption used was from the end of the range that resulted in the most favorable measurement outcome.

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Appendix – Management Bias (Auditing Guidance)

Indicators of Possible Management Bias (Ref: par. .32) .A133 Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods.

For example, if accounting estimates included in the financial statements are considered to be individually reasonable but management's point estimates consistently trend toward one end of the auditor's range of reasonable outcomes that provide a more favorable financial reporting outcome for management, such circumstances may indicate possible bias by management.

A134 Examples of indicators of possible management bias with respect to accounting estimates include the following:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances
- Selection or development of significant assumptions or the data that yield a point estimate favorable for management objectives
- Selection of a point estimate that may indicate a pattern of optimism or pessimism When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level.

Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions about the reasonableness of individual accounting estimates. However, in some cases, the audit evidence may point to a misstatement, rather than simply an indicator of management bias.

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Appendix – Management Bias (Auditing Guidance)

A135 Indicators of possible management bias may affect the auditor's conclusion about whether the auditor's risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management's judgments in making accounting estimates.

Further, indicators of possible management bias may affect the auditor's conclusion about whether the financial statements as a whole are free from material misstatement, as discussed in section 700, Forming an Opinion and Reporting on Financial Statements, or section 703, Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA.

A136 In addition, in applying section 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud.

Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Indicators of possible management bias that may also be a fraud risk factor may cause the auditor to reassess whether the auditor's risk assessments, in particular, the assessment of fraud risks, and related responses remain appropriate.

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Appendix – Mandatory Performance Framework Revisited

Valuation professionals should strive for **objective, reasonable, and supportable** PFI relevant for use in the valuation process with the understanding that management bias may exist and, if present, should be properly adjusted to expected cash flows (i.e., reflecting market participants' assumptions) in the analysis. **Management bias** is a lack of neutrality by management in the preparation of information. In order to evaluate PFI for reasonableness, the valuation professional must use professional judgment to identify the most reliable objective information available.

Valuation professionals who obtain management's PFI for use in their valuation procedures must review the PFI with the appropriate level of professional skepticism. **Professional skepticism** is an attitude that includes a questioning mind and a critical assessment of audit evidence.

AICPA AU 230 Due Professional Care in the Performance of Work

The valuation professional is responsible for evaluating whether the prospective financial information (PFI) provided by management **is representative of expected value and properly supported**.

Mandatory Performance Framework, A1.4.1

In circumstances in which the PFI is not representative of expected value, properly supported, or both, the valuation professional must determine the most appropriate way to align PFI and expected value. The valuation professional may elect to (Note: not an all-inclusive list):

- request management to revise its PFI,
- adjust assumptions in PFI,
- use either another present value method (for example, discount rate adjustment technique (DRAT), expected present value technique method 1 or 2 (EPVT1 or EPVT2, respectively)), or
- use an entirely different approach from the income approach.

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Appendix – Mandatory Performance Framework Revisited

- a. The identification of the party or parties responsible for preparation of the PFI.
- b. The process used to develop the PFI from the perspective of market participants.
- c. The explanation of key underlying assumptions used in the PFI such as revenue forecasts, percentage of market share captured by the entity, or how the forecast profit margins compare to those of other market participants.
- d. The steps used in, and results of, testing the PFI for reasonableness including, but not limited to
 - I. a comparison of the PFI to expected cash flows,
 - II. a comparison of the PFI to historical performance,
 - III. a comparison and evaluation of prior year's PFI against actual historical results (when prior PFIs are available), and
 - IV. an analysis of the forecast relative to economic and industry expectations
- e. An analysis of any evidence that contradicts management's assumptions or conclusions used in their PFI.
- f. The rationale for any adjustments made to management's PFI.
- g. Evidence that a mathematical and logic check was performed.
- h. The components of the prospective balance sheet and cash flow statements, if available

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Q&A and Thank you!



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