

A CAUTIONARY VALUATION TALE YOU DO NOT WANT TO EMULATE

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The Sting

On April 10, 2023, the founder and former Chief Investment Officer (CIO) of Infinity Q Capital Management (“Infinity Q” or “IQ”) — a New York-based investment advisor with approximately \$3 billion in assets under management (AUM) — was sentenced to 15 years in prison for participating in a scheme to defraud investors.

The US Attorney representing the Southern District of New York stated that the Founder and CIO “wove a complex scheme to defraud investors in Infinity Q’s investment funds, and he continuously lied to investors, auditors, and even the SEC...We hope this lengthy sentence resonates in the financial sector and deters anyone who may be tempted to lie to investors.”

The Set-Up

At the center of the scheme was a series of over-the-counter (OTC) derivative positions involving customized contracts that allowed counterparties to take positions on the volatility of underlying assets or indices. The CIO represented to the funds’ investors that these OTC derivative positions were held at fair value and that IQ utilized a third-party provider to estimate the fair values of these positions.

The Hook

In actuality, the CIO took an active role in the valuation of the positions, modeling them under terms that materially differed from the underlying contracts, providing false input entries to the third-party provider, and altering computer code used in the modeling process. The result was a material overstatement of fair values of the positions. In some cases, identical positions held by different funds had widely divergent values. In other cases, swap values would require negative volatility (statistically impossible) for the fair values to calculate correctly.



The Tale

To prevent IQ’s auditors from uncovering the fraud, the CIO provided the auditors with falsified term sheets and deal documents modifying the terms of the derivative positions. Similarly, when the SEC opened an investigation into IQ’s valuation practices, the CIO provided altered “original” deal documents and investor materials, and also created ex-post-facto Valuation Committee “notes” covering his activities.

The Wire

Once the scheme was discovered and the positions sold or unwound, IQ sold the derivative positions for hundreds of millions of dollars less than the stated fair values. For most months in 2020, the month-end net asset values (NAV) of the positions were overstated by more than 30%.

The Shut-Out

IQ and the SEC announced a settlement of the SEC's claims against IQ. The SEC does not allege that IQ committed any violations of the antifraud provisions of the federal securities laws; while the details of the final settlement are not known, a proposed resolution included a cash settlement of up to \$48,000,000. In addition, IQ has agreed to the appointment of a Special Master to oversee the remaining distribution of its assets.

The Takeaway

As more and more asset managers recognize, third-party valuation consultants provide critical insight into the valuation process, assisting managers to get it right and assuaging investors who live in a "trust, but verify" universe.

At the same time, asset managers need robust valuation policies and strong internal controls, as well as effective checks and balances. They need involved, empowered and independent valuation committees. They need strong communication between the fund and the independent valuation agent.

This case demonstrates that nailing the externalities while ignoring the internal, or vice-versa, is not enough. Both an effective external relationship with your valuation consultant and robust internal policies are required to avoid bad outcomes.

Empire Valuation Consultants has grown into one of the nation's leading and most respected independent valuation consulting firms, preparing 45,000 valuations and assurance engagements over our 30-year history. Our wealth of valuation experience includes nearly every industry and type of investment (equity, debt, real estate-backed assets, intellectual property and intangible assets), offering clients well-balanced valuations that are specifically tailored to each situation. The success of our refined valuation process is reflected in the firm's reputation in the marketplace. Time and again, asset managers, accountants, attorneys and bankers turn to us for timely, defensible, and comprehensible valuation work.



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