UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Administrative Proceedings Rulings
Release No. 4976/August 16, 2017

ADMINISTRATIVE PROCEEDING
File No. 3-17342

In the Matter of

RD Legal Capital, LLC, and
Roni Dersovitz

Order Granting Respondents' Rule 250(d) Motion On Valuation Allegations

Rule of Practice 250(d) permits Respondents to move for a ruling as a matter of law following completion of the Division of Enforcement's case in chief. 17 C.F.R. § 201.250(d). The 2016 adopting release for the rule notes that "it is the Commission's view that proceedings designated for the longest timeframe will rarely be amenable to resolution based solely on the Division's case in chief . . . and therefore . . . Rule 250(d) motions should be granted in only the rarest of cases." Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50,212, 50,225 (July 29, 2016). But "rarely" does not mean "never," and the Commission would not have added Rule 250(d) unless it believed that some circumstances would merit granting motions made under the rule.

Such is the case here. This order grants, on reconsideration, Respondents' motion under Rule 250(d) for a ruling as a matter of law, dismissing the Division's allegations that Respondents inappropriately valued their funds' holdings. I previously denied the motion during the hearing. But having more fully considered the Division's case in chief, I now determine that the motion should have been granted when it was made; the valuation allegations are unfounded, so they fail. This ruling does not concern the Division's other allegations, which will be addressed in a subsequent initial decision.

I. Procedural History

On July 14, 2016, the Securities and Exchange Commission issued an order instituting proceedings (OIP) against Respondents. Among other

things, the OIP alleges that Respondents defrauded investors "by withdrawing money from [two] funds using valuations [of legal receivables] based on unreasonable assumptions, thereby draining the funds of liquidity at the expense of investors." OIP ¶ 1. More specifically, it alleges that Respondents engaged an agent—Pluris Valuation Advisors LLC—for valuation services to determine "the value of the Funds' receivables by discounting to present value the amount Respondents expected the receivable to pay at a projected future payment date." *Id.* ¶ 61; Div. Prehr'g Br. at 21. This valuation derived from inputs Respondents provided to Pluris; but, according to the OIP, these inputs underrepresented the riskiness of the legal receivables in which the funds were invested. *See generally* OIP ¶¶ 61-70.

The OIP further explains that "[t]he primary inputs affecting this present value calculation (other than the amount of the receivable purchased) were the expected date of payment and a discount rate for the position." *Id.* ¶ 62. Such inputs—provided by Respondents—were allegedly deficient in the following ways:

- The discount rate was derived from receivables related to "settled or otherwise resolved cases, where the primary risk was timing rather than litigation outcome," whereas the funds were increasingly invested in receivables related to unsettled cases. *Id.* ¶ 64.

- The portfolio applied several possible discount rates based on a receivable's "rating," which represented the nature or quality of the investment. *Id.* ¶ 65. Respondents provided Pluris with a rating for each receivable, which "required an understanding of the nature of the underlying litigation, including its likelihood of success." *Id.* Yet Pluris's employees were not lawyers and did not understand the legal issues underlying the litigations in which the funds invested. *Id.*

- A "yield rate" accounted for whether there was collateral for a given receivable. For receivables the funds purchased from plaintiffs in *Peterson v. Islamic Republic of Iran*, No. 10-CV-4518 (S.D.N.Y.), the relevant assets were subject to claims of many other plaintiffs, introducing risk that the recovery would be insufficient

to satisfy the entire judgment for a particular plaintiff.[1] OIP ¶ 66. Yet for these receivables, Dersovitz instructed Pluris to include collateral equal to the entire size of the default judgment for each plaintiff. *Id.*

- For other receivables associated with unsettled litigation, Dersovitz provided his expected repayment dates and later extended them, resulting in the continued accrual of interest from those investments. *Id.* ¶ 67. Dersovitz provided to Pluris extended repayment dates concerning matters where he had agreements to extend such dates and in other instances where he had no such basis to extend the repayment dates. *Id.*

- Respondents failed to disclose to Pluris changes impacting the collectability of receivables in certain cases—including receivables from two law firms[2]—which "in turn led to inflated valuations for assets in the Funds by understating their riskiness." *Id.* ¶¶ 68-69.

These deficiencies allegedly allowed Respondents to withdraw more cash based on the "unreasonably inflat[ed]" valuations, while investors merely received "monthly IOUs" based on speculative profits. *Id.* ¶ 70. The OIP further contends that Dersovitz, facing a liquidity crisis, recruited a third-party investor to purchase fund assets so as to bring cash into the funds, and in so doing, elevated his own interests over investors' interests. *Id.* ¶¶ 71-74.[3]

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[1] *Peterson* involved "the pursuit, by numerous plaintiffs, of assets from the Islamic Republic of Iran on the basis of default judgments they had obtained for victims and relatives of the 1983 Marine barracks bombing in Beirut." OIP ¶ 21. According to the OIP, "[b]y August 2012, the *Peterson* Receivables were valued at over 20% of the Funds' portfolio, a proportion that grew to approximately two-thirds of the portfolio by the middle of 2014." *Id.*

[2] These two law firms are hereafter referred to as "Cohen" and "Osborn." The Cohen and Osborn receivables, as well as the *Peterson* receivables, are those with which the Division takes particular issue and that are together called the "Contested Receivables." Div. May 5, 2017 Letter at 1.

[3] The Division's allegations parallel a Wall Street Journal article published a year before the OIP with the headline *Hedge Fund That Bet on Bombing Judgment Takes Early Payouts*. Ex. 56 (admitted into evidence but not for the truth of the matters it asserts, *see* Hr'g Tr. 1128). Of RD Legal, the article reported that:

On February 15, 2017, towards the conclusion of prehearing discovery, Respondents submitted a request for leave to file a motion for summary disposition under Rule 250(c), along with the accompanying motion. In relevant part, Respondents sought summary disposition as to "any claims related to the valuation of the funds' portfolio," arguing that "the uncontroverted evidence establishes" that the valuations were reasonable and that "[t]here is no evidence the Division can present to suggest that the assets were *not* reasonably valued."[4] Summary Disp. Mot. at 2; *see generally id.* at 8-25. The administrative law judge previously assigned to this matter denied the request for leave as untimely because it came too close to the impending hearing date. *RD Legal Capital, LLC*, Admin. Proc. Rulings Release No. 4622, 2017 SEC LEXIS 567, at *2-3 (ALJ Feb. 23, 2017).

Respondents again sought a ruling on the valuation issue during the March 13, 2017, prehearing conference, requesting an offer of proof from the

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> *The firm is using a series of complex accounting maneuvers that allow it to increase the value of the terror claims*, which comprise more than 70% of the portfolio of its main fund, documents show.
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> According to marketing documents and people familiar with the firm, an arm of RD Legal buys those claims from victims at a steep discount, in many instances paying victims less than half what they would be entitled to if the judgment is paid. Such arrangements are common in the business of buying claims, though the discounts can vary widely.
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> *Under the rules of the fund, a committee comprised solely of RD Legal employees, advised by a third-party valuation firm, then revalues the claims*, investor reports indicate. *Documents show RD Legal steadily increased the paper value of the claims, lifting them closer to their full value. That has allowed the hedge fund to book gains on the investments*—ahead of any certainty on the outcome of the case—*and collect its corresponding cut of any profits*, according to the documents and people familiar with the firm.

Ex. 56-3 (June 1, 2015) (emphases added).

[4] The motion also sought summary disposition as to "the Division's request for Tier III penalties." Summary Disp. Mot. at 2. What penalties—if any—are imposed on Respondents, and at what tier(s), are matters that I will address in the initial decision.

Division to get past a dispositive motion. Prehr'g Tr. 46. I detailed the Division's response in the order following the conference:

> The Division stated during the conference that it is not pursuing standalone claims relating solely to the valuations at issue and that this is a "misrepresentations case" where investors were told that the funds were lower risk than they actually were. Yet the Division retains the contention that the valuations "look[ed] at cases as if they[were] all settled" when the funds were actually "invest[ed] in other things" with "other risks," and that this enabled Respondents to defraud investors by drawing money from the funds in a manner inconsistent with the funds' actual risk profile. This characterization seemingly implicates the reasonableness of the valuations, as it suggests such valuations were "inflated" and did not comport with the true riskiness of the investments (albeit due to Dersovitz's "fail[ure] to disclose" relevant information to the valuation agent).

RD Legal Capital, LLC, Admin. Proc. Rulings Release No. 4683, 2017 SEC LEXIS 774, at *6 (ALJ Mar. 15, 2017) (internal citations to the transcript and OIP omitted). Also during that prehearing conference, the Division characterized its valuation argument in the following manner:

> [T]o the extent that there's valuation attached to this case, it's simply that respondents . . . were able to pull money out based on the valuations that they were getting monthly . . . . Meanwhile, investors had to wait until these cases were resolved, and they weren't the kind of cases that respondents said they would be investing in.
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> Probably the best way to think of it is: A particular claim might have been valued at a dollar. We're not coming in—and that's why we don't have an expert on this, because I know respondents asked that question in their briefing—we're not coming in and saying, "That valuation shouldn't have been a dollar, and therefore violated the securities laws."
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> But there's a big difference between something that's valued at a dollar because there's a 100 percent chance

> you're going to get the dollar and something else that's valued at a dollar because there's a 50 percent chance you're going to get $2. By investing in a bunch of the latter category, respondents violated the securities laws because they misrepresented to investors what they were going to invest in.

Prehr'g Tr. 47-48. I ultimately deferred ruling on Respondents' request at the conference and instead instructed the parties to submit, if they could agree on one, a stipulation regarding the scope of the Division's asserted claims on valuation. Prehr'g Tr. 49; *RD Legal Capital, LLC*, 2017 SEC LEXIS 774, at *6-7. The parties could not agree on such a stipulation, and at the start of the hearing I indicated that Respondents could make a renewed Rule 250 motion at the close of the Division's case in chief. *See* Hr'g Tr. 15, 18.

Following the Division's case in chief, Respondents moved under Rule 250(d) for a ruling as a matter of law on the valuation issue, citing a lack of evidence to support the OIP's allegations and contrary evidence showing "that RD Legal engaged in a bona fide, well-recognized process for evaluating these . . . assets." Hr'g Tr. 3932-34. In response, the Division argued there was evidence of the "unreasonable assumptions" underlying the valuation of the funds which had "been testified to by many investors." Hr'g Tr. 3936. That is, investors "thought they were buying . . . receivables in settled cases" and the valuation agent likewise "based [its] model on sales relating to . . . settled litigation." Hr'g Tr. 3936-37. Yet, the funds were significantly invested in unsettled cases and the valuation unreasonably "treat[ed] those cases the same way you treat real settlements" thereby "allow[ing Respondents] to withdraw [more] money along the way." Hr'g Tr. 3939-40. But similar to its statement during the prehearing conference, the Division also said:

> [T]his is not a valuation case in the traditional sense where . . . we think it's $1, you say it's $2 . . . and we're going to put on an expert explaining why we think your [valuation] is improper.
>
> No. It's the whole unreasonable assumptions that went into how you're withdrawing money and putting that risk on investors.

Hr'g Tr. 3940. I expressed some skepticism at the Division's argument because it was unsupported by expert testimony and seemingly discounted the possibility that, even if Respondents made misrepresentations to investors, they could have nonetheless obtained reasonable valuations from Pluris. Hr'g Tr. 3955-56. Moreover, the Division did not articulate why—

given the OIP's allegations that Respondents withdrew more cash based on unreasonably inflated valuations, OIP ¶¶ 1, 70—the valuations operated as a fraud on investors if the Division was not contending such valuations were inaccurate or improper. *See* Hr'g Tr. 3956-60. I noted that I was close to granting Respondents' motion, but ultimately denied it so that I could more fully consider the evidence. Hr'g Tr. 3962.

Given the paucity of evidence the Division presented at the hearing on its valuation allegations—and the absence of any reference to it in its closing argument—Respondents' Rule 250(d) motion appeared to have potential merit, so following the hearing I ordered that the Division make a submission identifying all hearing evidence supporting the OIP's allegations that the funds' valuations were unreasonable and inflated. *RD Legal Capital, LLC*, Admin. Proc. Rulings Release No. 4781, 2017 SEC LEXIS 1304, at *1 (ALJ May 2, 2017). I also permitted Respondents to submit a response explaining why I should reconsider their Rule 250(d) motion. *Id.*

The Division's May 5 letter argues that the valuation methodology caused investments in long-duration legal receivables to "jump in their value" at the point of initial investment, enabling Respondents to immediately "capitalize" by collecting fees according to the higher valuation. Div. Letter at 2, 4. Based on investor testimony, the Division says this was "problematic" because the funds were significantly invested in non-settled cases. *Id.* at 2. Citing various exhibits and portions of the transcript, the Division's submission then enumerates reasons why it believes the valuation methodology did not account for litigation risk, *id.* at 3-4, and further enumerates why Respondents' withdrawals based on that methodology put cash out of investors' reach when investment outcomes were poorer than anticipated, *id.* at 4-6. According to the Division, that the funds still had to borrow money despite receiving a large payout from the *Peterson* receivables is evidence that the valuation methodology led to Respondents withdrawing money too early from the funds. *Id.* at 6. And, whereas Respondents have suggested their valuation approach was reasonable based on values at which they sold assets to third parties, the Division argues this is untrue and that such assets were sold at more modest values that further evidence the unreasonableness of Respondents' withdrawals based on higher values. *Id.*

According to the Division, it has never alleged "that Respondents 'cooked the books,' . . . and the Division does not oppose summarily disposing of such a (nonexistent) claim." Div. Letter at 1; *see id.* at 2 n.1 ("when the Division uses the words 'high' or 'inflated' values, it . . . does not mean 'cooked' or 'invented' or 'incorrect' values"). But given the Division's claims that Respondents withdrew too much money from the fund too soon using "inflated" and "unreasonable" valuations, it is difficult to cast such

allegations in any other light. *See* OIP ¶¶ 1, 68-70; *see also* Rob Copeland and Aruna Viswanatha, *Hedge Fund that Bet on Terror Lawsuit is Accused of Fraud by the SEC*, Wall St. J., (July 14, 2016), http://on.wsj.com/2tmHvcy (noting the OIP alleged that Respondents "artificially boosted the values of their holdings").[5]

On May 12, Respondents submitted a letter in response (Resp. Letter), renewing their Rule 250(d) motion and again arguing that the evidence shows the valuations were reasonable and that there is no evidence supporting the Division's assertions to the contrary.

II. Standard Governing Rule 250(d)

Rule 250(d) provides that "[f]ollowing the interested division's presentation of its case in chief, any party may make a motion, asserting that the movant is entitled to a ruling as a matter of law on one or more claims or defenses." 17 C.F.R. § 201.250(d). That Rule's 2016 adopting release provides that "[t]his is analogous to Federal Rule of Civil Procedure 50(a) (judgment as a matter of law)." 81 Fed. Reg. 50212l, 50225 n.124. Federal Rule of Civil Procedure 50(a) provides, in pertinent part, that "[i]f a party has been fully heard on an issue" and the fact finder "would not have a legally sufficient evidentiary basis to find for the party on that issue," then the court may: "(A) resolve the issue against the party; and (B) grant a motion for judgment

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[5] *Cf. O'Melveny & Myers v. FDIC*, 512 U.S. 79, 81 (1994) (in reciting stipulated facts, stating that individuals "fraudulently overvalued . . . assets, . . . create[d] inflated 'profits,' and generally 'cooked the books' to disguise . . . dwindling (and eventually negative) net worth"); *cook the books*, Oxford English Dictionary, https://en.oxforddictionaries.com/definition/cook_the_books (last visited June 29, 2017) (defining "cook the books" as to "[a]lter facts or figures dishonestly or illegally"). The use of "cooking" to describe the surreptitious alteration of an object may date back to 1630s England, when the Earl of Strafford so used the phrase in his *Letters and Dispatches*. Gary Martin, *Cooking the Books*, The Phrase Finder, http://www.phrases.org.uk/meanings/cook-the-books.html (last visited June 29, 2017); *see* Douglas Harper, Online Etymology Dictionary, http://www.etymonline.com/index.php?allowed_in_frame=0&search=cook (last visited June 29, 2017) (using "cook" in the figurative sense of "to manipulate, falsify, doctor" dates to the 1630s). The phrase's reference to the alteration of financials specifically may date to 1751, when it appeared in Tobias Smollett's *The Adventures of Peregrine Pickle*, describing "[s]ome falsified printed accounts, artfully cooked up, on purpose to mislead and deceive." Martin; *see also* 2 John S. Farmer, *Slang and its Analogues* 173-74 (1891) (detailing Smollett's use of the term, as well as subsequent uses in the nineteenth century).

as a matter of law against the party on a claim . . . that, under the controlling law, can be maintained or defeated only with a favorable finding on that issue."

As explained below, the Division's case in chief concerning valuation did not establish that the valuations in question were unreasonable or inflated and thus fails as a matter of law. I base my ruling on the insufficiency of the Division's case alone. Moreover, none of the relevant valuation evidence adduced following the Division's case in chief undermines this conclusion, but rather only confirms it.

III. Valuation Expertise

Pluris's valuations of the legal receivables at issue were complex. *See, e.g.*, Ex. 355A (Pluris valuation model); Hr'g Tr. 1936. Often, in cases involving financial complexities, "the need for an expert" on valuation to establish allegations such as "cooking the books" is clear. *APA Excelsior III, L.P. v. Windley*, 329 F. Supp. 2d 1328, 1337-38 (N.D. Ga. 2004). And where valuations issues are complex, as here, expert testimony may well prove "critical to the resolution" of a proceeding. *PSM Holding Corp. v. Nat'l Farm Fin. Corp.*, No. No. CV 05-08891, 2015 WL 11251950, at *7 (C.D. Cal. July 14, 2015); *cf. Monopoly Hotel Grp., LLC v. Hyatt Hotels Corp.*, 291 F.R.D. 684, 689 (N.D. Ga. 2013) (party's expert taking over thirty days to respond to damage calculations was "not unjustified given the nature of the case" involving "an alleged $100 million dispute involving valuations of revenue streams"); *N. Nat. Gas Co. v. Approximately 9117.53 Acres*, No. 10-1232, 2011 WL 4337146, at *2 (D. Kan. Sept. 15, 2011) (adopting magistrate judge's recommendation that "the character of the property to be taken was so complex that various types of expert testimony would be required"). And when such expert evidence is offered, it is "particularly important that the opponent of [complex expert] valuations be offered the opportunity to test their conclusions by cross-examination." *LJL 33rd St. Assocs., LLC v. Pitcairn Props. Inc.*, 725 F.3d 184, 194 (2d Cir. 2013).

The Division did not seek to present a report or testimony of a retained valuation expert to support its valuation allegations. Respondents contend that it is "telling that the Division never presented the issues of how Respondents valued the assets in the portfolio to the Commission's Division of Economic Risk and Analysis ('DERA')." Resp. Letter at 2. DERA "was created . . . to integrate financial economics and rigorous data analytics into the core mission of the SEC." Securities and Exchange Commission, *About the Division of Economic and Risk Analysis*, https://www.sec.gov/dera/about (last modified Jan. 18, 2017). DERA's activities include, among other things, "providing detailed, high-quality economic and statistical analyses, and

specific subject-matter expertise to the Commission and other Division/Offices." *Id.* In light of DERA's role, Respondents requested that the Division produce any information from DERA related to this matter. *See* Hr'g Tr. 25. In response, the Division revealed that: "[t]he truth is we didn't ask for and we never got any information from DERA, so this is just an example of they're hoping to fish. Well, here you go, you caught the fish: There's no DERA report and there was no request for a DERA report." Hr'g Tr. 27. According to Respondents, "one would expect the Division would have consulted DERA on" whether "Respondents assigned 'unreasonable' values to the assets." Resp. Letter at 2.

Although it would have been reasonable for the Division to consult with DERA or otherwise retain a valuation expert, it was not required to do so. But the lack of any expert evidence from the Division in support of its valuation allegations, at any point in the case, is a factor that I consider in deciding Respondents' motion. *Cf. Nat'l Credit Union Admin. Bd. v. UBS Sec., LLC*, Nos. 12-2591 and 12-2648, 2016 WL 7496106, at *5 (D. Kan. Dec. 30, 2016) (noting lack of "any expert evidence suggesting that a [discounted cash flow] analysis could not be used reliably to determine the value of" over-the-counter securities in an illiquid market, and further noting plaintiff's failure to "support[ ] its [valuation] argument with any expert testimony of its own"); *APA Excelsior III, L.P.*, 329 F. Supp. 2d at 1337-38 (underscoring the obvious importance of expert testimony to substantiate similar allegations).

IV. The Division Failed to Establish the Valuation Allegations

The Division's principal argument in support of its valuation allegations is that Respondents' valuation method failed to account for so-called "litigation risk"—*e.g.*, if a plaintiffs' attorney does not collect in a case, it adversely impacts her ability to pay RD Legal. According to the Division: "Respondents applied the same valuation assumptions to the *Peterson*, Osborn and Cohen positions (the 'Contested Receivables') as they did the virtually riskless (from a litigation perspective) receivables in settled cases. This valuation method assumed the only risks to be duration and credit risk, not collectability due to litigation risk." Div. Letter at 1. More specifically, the Division claims "[t]he expected date of payment and a discount rate were the primary inputs affecting the [discounted cash flow] calculation" that Respondents used to value the Contested Receivables, and "litigation risk was not counted" because "[t]he discount rate was derived based on the implied rate of return RD Legal Capital had achieved on the sale of receivables that related to settled or otherwise resolved cases." Div. Letter at 3.

The Division supports its position with various citations to record evidence. As described below, however, most of this evidence does not support, and in many instances undermines, the Division's valuation allegations.

The most relevant of this evidence is the testimony of Espen Robak,[6] who is founder and president of Pluris. Hr'g Tr. 1818; Ex. 497 at 1. He holds a B.S. in Finance and an MBA from the University of Oregon, as well as a Chartered Financial Analyst credential. Ex. 497 at 1. Robak is "a nationally recognized expert" on valuation, illiquid securities, and "discounts for lack of liquidity." *Id.* He "is a frequent contributor to books and professional journals on valuation." *Id.* at 1-3. Many of his publications and speaking engagements pertain to the valuation of illiquid securities. *Id.* at 2-4. In addition to his work at Pluris, which involves providing "valuation services for portfolio valuation," a variety of his other experiences are pertinent here:

> Mr. Robak's career has been focused on the valuation of, and research on, hard-to-value, illiquid, and distressed securities . . . . Mr. Robak's business valuation experience also encompasses intangible assets and intellectual property valuations, assignments involving the allocation of value between several classes of stock, and the valuation of derivative and hybrid securities.
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> Prior to forming Pluris, Mr. Robak was Senior Vice President of FMV Opinions, a business valuation firm, and directed the firm's restricted stock and blockage discount practices, including directing the FMV Restricted Stock Study, a published database of private placement transactions, as well as several publications on private placements, restricted stock, and marketability discounts.

Id. at 1. Robak has also provided expert testimony and reports on valuation matters. *Id.* at 4-5.

Robak testified that Pluris's model for valuing the funds' legal receivables had "many, many inputs." Hr'g Tr. 1844. The model itself is a complex spreadsheet containing seventy-two columns for different inputs. *See*

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[6] Both the Division and Respondents called Robak as a fact witness, and he testified for both sides on the same day. Hr'g Tr. 1814. The portions of his testimony on which I rely in this section are within the scope of the Division's direct examination of him.

Ex. 355A ("Model 6.30.13" tab). Included among the many inputs were: "(1) the Receivable amount, or legal fee amount purchased, (2) the interest rate implicit in the Receivable arrangement and purchase price, (3) the rating of each Receivable as provided by [RD Legal], (4) the net book value of each Receivable . . . and (5) the contract funding date and ending date." Ex. 161 at 8; Ex. 247 at 3; *see also* Hr'g Tr. 1844-50 (Robak describing each of these inputs). As to the mechanics of the valuation process, Robak explained that:

> [W]e construct essentially a very large spreadsheet which you have seen every month with data points on when the receivables are expected to be paid, what the amount is likely to be at that point, how those amounts are then discounted back to the present. We often look at it in multiple ways. We viewed the cash flows estimated payable at various points in time. But it all results in various estimates of the present value, discounted present value. And then those are averaged, and [we] draw a conclusion for each item.

Hr'g Tr. 1838. For these valuations to reflect the risk of the various legal receivables in which the funds were invested, Pluris would "look at the income or cash flow that a particular asset is likely to produce at some point in the future, and then . . . discount that back to the present using a discount rate" for each receivable, which results in a present value. Hr'g Tr. 1830, 1860, 1875. Pluris adjusted the discount rates for each receivable on a monthly basis. Hr'g Tr. 1862. Generally, Pluris assigned higher discount rates to receivables it perceived to be higher risk. Hr'g Tr. 1848.

Robak testified repeatedly that the discount rate reflected the risk of nonpayment. *See* Hr'g Tr. 1833, 1835-36, 1848, 1909, 1917-18. Accordingly, though Pluris's model did not specifically quantify litigation risk as a category or specific number, Hr'g Tr. 1912, 1918, the model still accounted for the ultimate risk posed by a Contested Receivable losing out in litigation—that the receivable would not pay. Robak stated this several times, testifying that litigation risk was captured in the discount rates via the risk of nonpayment. Hr'g Tr. 1909-10, 1917. And nonpayment was one of "a great number of risks" that were "captured in the discount rate[s]," which Robak remarked were "very, very high." Hr'g Tr. 1910.

Further, Robak noted that the discount rates reflected Pluris's opinion for the portfolio, that Pluris "did look at the review of the legal risks that were presented," and ultimately had "a view of the discount rates that [were] appropriate" for those risks. Hr'g Tr. 1911. For example, Pluris discussed the Osborn positions with the Osborn firm and RD Legal, and received reports

from other firms on the topic. Hr'g Tr. 1910-12, 1940-41. And Pluris determined that those receivables had a "substantially increased risk" of nonpayment. Hr'g Tr. 1898-99; *see* Hr'g Tr. 1829. This increased risk resulted in Pluris "adjust[ing the] discount rate on the Osborn receivables upwards by a very wide margin over time." Hr'g Tr. 1940, 1980-81; *see* Hr'g Tr. 1896. Robak similarly noted a "significant increase in the risk of nonpayment" regarding the Cohen receivables. Hr'g Tr. 1899. And he said Pluris "had discussions with the Perles law firm," lead counsel for plaintiffs in the *Peterson* case, recalling that Perles provided "detailed analysis" to Pluris about *Peterson*, including "what happened up to that point in time, what was likely to happen, [and] all the multiple avenues that that case could take," leaving Pluris "very comfortable" concerning the likelihood of collecting. Hr'g Tr. 1910-11, 1962.

The Division makes much of Robak's testimony that one of the inputs into the discount rate, a yield matrix, was derived from the Brevet portfolio—a group of previously sold legal receivables that the Division contends related only to settled cases. *See* Hr'g Tr. 1881-88, 1893, 1909; Ex. 355A ("Yield Cal on Cases Sold" tab); Div. Letter at 3-4. But there is little basis to conclude that Pluris's use of empirical data from that prior portfolio as a mere starting point for deriving discount rates, Hr'g Tr. 1882, 1987, necessarily means litigation risk was unreasonably or insufficiently reflected in Pluris's ultimate model. This is apparent given Robak's aforementioned testimony about discounting for the risk of nonpayment, as well as the fact that the model had "many, many inputs" and accounted for multiple other risks like illiquidity and timing. Hr'g Tr. 1844, 1910, 1918. These facts beg the question—one not answerable without the benefit of expert testimony—of whether and how the valuations would have differed were the model somehow recalibrated to the Division's liking. *See* Hr'g Tr. 1989; *see also* Hr'g Tr. 1918 (Robak testifying that the model "captures *our full view* in our judgements of what the discount rate should be in an arms' length transaction" (emphasis added)). *Cf. Nat'l Credit Union*, 2016 WL 7496106, at *5 (rejecting criticism of defendant's complex valuation where "plaintiff has not supported its argument with any expert testimony of its own"). For example, the credit rating that RD Legal provided to Pluris for each receivable—an input about which the Division complains, *see* OIP ¶ 65—did not have a substantial impact on valuation and only slightly correlated to the discount rate, according to Robak. Hr'g Tr. 1847.

As to the other evidence the Division cites, there is nothing in the Fund's financial statements evidencing a failure to account for litigation risk or that counters Robak's testimony regarding such risk being appropriately captured through the discount rate. *Cf.*, *e.g.*, Ex. 16 at 16 (noting certain inputs are

only "an element of" valuation and that valuation firm will apply higher discount rates for "higher risk situations"). Moreover, the financial statements are replete with language stressing the significant judgment and uncertainty involved in valuing "Level 3" assets with "unobservable inputs" like the legal receivables at issue. *Id.* at 15-16; *see generally* Exs. 11-19. Indeed, the financial statements even caution that "[t]he inputs or methodology used for valuing Level 3 assets are not an indication of the risk associated with investing in those Level 3 assets." *E.g.*, Ex. 16 at 16. This belies the Division's implied premise that the valuation model should have explicitly distinguished between "something that's valued at a dollar because there's a 100 percent chance you're going to get the dollar and something else that's valued at a dollar because there's a 50 percent chance you're going to get $2." Prehr'g Tr. 47-48. And the Division never adequately explains why that distinction matters for purposes of *valuation methodology* (as opposed to statements to investors); it is not arguing the dollar values assigned to the receivables were wrong, Prehr'g Tr. 47-48, and the withdrawals about which the Division complains were based on those ultimate dollar values, *not* risk profile, *see* OIP ¶ 70; Div. Letter at 1 ("the amount that Respondents were able to withdraw from the Funds was tied to the assigned value of those Funds' assets").[7]

Also unpersuasive is the Division's reliance on the testimony of investor-witnesses Alan Mantell and Asami Ishimaru. The Division cites Mantell's view that a portfolio with litigation risk meant that his "investment position has no more validity than the way in which somebody is marking these assets to market." Div. Letter at 2 (citing Hr'g Tr. 669). Similarly cited are Ishimaru's statements that where "there was a risk that the defendant would not have to pay the settlement" Respondents "would collect incentive fees on interest[s] that didn't materialize, leaving investors with no recourse given the lack of claw back available against Respondents' draws." *Id.* at 2 (citing Hr'g Tr. 299-300, internal quotation marks omitted). But again, there is no evidence that the method Pluris used to mark the assets was invalid. As already discussed, because Pluris's monthly valuations took into account nonpayment risk through discounting the value of the positions, and because there is no evidence that those valuations were unreasonable, there is no

[7] In its post-hearing brief, the Division does not address valuation but relies on its May 5, 2017, letter, and notes that "the Court need not find the valuations to be improper to hold that Respondents should not be permitted to retain the profits from the fraudulent misrepresentations addressed herein." Div. Post-hr'g Br. at 42 n.43. I do not disagree, but what illicit profits, if any, are causally connected to actionable misrepresentations or omissions, if any, is a determination I reserve for the initial decision.

basis to believe Respondents wrongly collected fees on the assessed value of the portfolio.

The cited testimony of the investor-witnesses and the arguments of the Division are less an objection to the valuations—the accuracy of which the Division does not ultimately contest—and more to the terms of the funds that permitted Respondents to withdraw gains monthly. As Respondents point out, this is also true of the Division's assertions that by withdrawing such gains, Respondents "pulled cash out of the funds" and put cash "further out of each of investors," leaving investors with merely "paper returns" and IOUs. Div. Letter at 4-6. The Division overlooks the disclosure in the offering documents to which every investor agreed, permitting withdrawals based on unrealized gains: "At the end of each month, net profits and net losses of the Partnership (including realized and unrealized gains and losses) from investments held in the partners' capital accounts will be allocated to the limited partners" up to a certain amount, with "[a]ny net profits in excess . . . allocated to the General Partner's capital account." *E.g.*, Ex. 66 at 7.[8] That is, redeeming investors could withdraw cash from the Funds "based on unrealized gain" just as the general partner could. Hr'g Tr. 365 (Ishimaru conceding this point). And partly based on these unrealized gains, investors "were able to redeem [their] investment[s] . . . and make . . . profit." Hr'g Tr. 365; *see* Hr'g Tr. 240-243.

In sum, there is insufficient evidence to conclude that Respondents' valuation methodology—or the manner of the withdrawals based on those valuations—were unreasonable or improper. As such, the record on valuation does not support a finding of liability under the Securities Act of 1933 Section 17(a) or the Exchange Act of 1934 Section 10(b) and Rule 10b-5. *See* OIP ¶ 75. Having carefully scrutinized the Division's recitation of all evidence on this issue, I find that, as a matter of law, its allegations on valuation amount to nothing.

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[8] The Division's suggestion that Respondents' valuation was unreasonable because Respondents had to lend money to the funds in 2016, Div. Letter at 6, is somewhat specious for two reasons. First, periods of illiquidity do not demonstrate the valuations were unreasonable; indeed, as described above these receivables were known to be illiquid. Second, the Division does not address the possibility that the pendency of its enforcement action may have adversely impacted Respondents' ability to operate as profitably as before. But this motion does not require that I make specific findings on those two issues.

V. Valuation Evidence Following the Division's Case

Although I base my ruling on the insufficiency of the Division's case alone, Respondents' subsequent valuation evidence—briefly summarized, in part, below—only confirms the lack of support for the valuation allegations. In addition to taking direct testimony from Robak, Respondents presented testimony of valuation experts David X. Martin and Leon M. Metzger, who were specially retained for this proceeding, as well as Dennis Schall, the lead audit partner for the funds' outside auditor, Marcum, LLP.[9]

1. Espen Robak

On Respondents' direct examination of him, Robak vouched for the reasonableness and independence of Pluris's valuations, noting that Pluris made the final determinations in its reports based on the data. Hr'g Tr. 1948-50, 1976-82. And according to Robak, that data was sufficient to independently value the portfolio assets. Hr'g Tr. 1982. He further emphasized that Pluris's model was designed to cover the "portfolio as a whole" rather than a handful of individual positions, and that when applied "in an unbiased way," the model would offset errors in each direction to arrive at reasonable valuations. Hr'g Tr. 1977.[10]

2. David X. Martin

Martin is a recognized valuation expert with undergraduate and master's degrees in accounting and business administration, respectively. Ex. 2393 at 3, 51. He is a Certified Public Accountant and since 2011 has served as an adjunct professor at New York University's and Fordham University's graduate schools of business. *Id.* at 3-4, 50. For nine years, he was chair of the Valuation Committee at AllianceBernstein, responsible for the daily pricing of nearly $850 billion in assets under management. *Id.* at 3. He "also served as a senior executive at Citicorp responsible for . . . the pricing of roughly two trillion dollars of client assets." *Id.*

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[9] The Division does not challenge the expertise or credibility of Respondents' experts, and it did not undercut their opinions on cross-examination. *Cf. LJL*, 725 F.3d at 194 (highlighting the importance of testing expert conclusions).

[10] There is also evidence indicating that net collections on various receivables have been, on balance, in line with the portfolio valuations. *See generally* Resp. Letter at 6.

On the question of whether RD Legal's valuation and risk management procedures were reasonable and consistent with industry standards, Martin concluded in his expert report that:

> RD Legal acted appropriately and consistent with industry practices when assessing, marking, and reporting the value of assets comprising the investment portfolio it managed. Specifically, RD Legal: (a) conducted comprehensive due diligence and obtained an information advantage before purchasing receivables; (b) employed a sound fair market value approach to mark the positions in its investment portfolio in accordance with FASB #157; (c) properly relied on fully independent monthly asset valuations provided by third party Pluris Valuation Advisors LLC; and (d) adequately and accurately reported the composition and performance of the portfolio to investors.

Id. at 7-8. Martin also testified that Pluris factored "legal risk of the receivable . . . into [the] discount rates" and that its process was independent. Hr'g Tr. 4039-40, 4106.

3. Leon M. Metzger

Metzger holds a bachelor's degree from the Wharton School at the University of Pennsylvania and a master's degree from Harvard Business School. Ex. 2396 at 4. He has "29 years of professional experience in the hedge fund industry, both in senior positions at an alternative investment firm and in academia." *Id.* at 3. This experience includes, among other things: serving on the valuation committee for a firm managing up to roughly $3 billion in assets; serving as a member of the Investor Risk Committee of the International Association of Financial Engineers, as chair of its advisory board, and as a principal author of its valuation concepts white paper; lecturing on issues related to valuation to Commission staff; and appearing as a valuation expert before a number of government agencies. *Id.* at 3-4.

Here, Mr. Metzger was asked, in pertinent part, to provide an expert opinion as to "[w]hether the procedures used by [RD Legal] for valuing the assets in the funds' portfolios conformed to valuation principles and were reasonably designed to result in a fair valuation." *Id.* at 5. In his opinion, they did. *Id.* at 5, 42-49.

He found that Respondents comported with key valuation principles, including "acting in good faith" as a result of "a sincere and honest assessment" in determining valuations, treating investors equitably,

generally performing valuations at appropriate intervals, disclosing the valuation policy and process to investors, and verifying those valuations. Hr'g Tr. 5164-67; Ex. 2396 at 42-48. In addition, he opined that "the SEC's own guidance . . . highlights that some funds . . . give their managers significant discretion in valuing illiquid securities" and "may invest in securities that are relatively illiquid and difficult to value." Ex. 2396 at 14; *see id.* at 13-14 (quoting 2012 investor bulletin issued by Commission staff); *see also id.* at 10-11 & n.18 (quoting 2003 staff report to Commission on growth of hedge funds). He further noted that the guidance "emphasizes that investors should ask questions and assume the risk of their investment." *Id.* at 14

4. Dennis Schall

Schall was lead audit partner for Marcum, LLP, the RD Legal funds' outside auditor. He testified that as part of its audit process, Marcum analyzed Respondents' valuations by "employ[ing] [its own] internal valuation team to review . . . [Pluris's] independent valuation report." Hr'g Tr. 3158. On this team was Marcum's internal valuation specialist, who reviewed Pluris's valuation model, methods, and assumptions and determined that Pluris's "valuations were reasonable." Hr'g Tr. 3159-65.

VI. Order

It is ORDERED that Respondents' Rule 250(d) motion is GRANTED. OIP paragraph 1(ii), and the portions of OIP paragraphs 60-74 that allege any misconduct related to valuation, are DISMISSED.

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Jason S. Patil
Administrative Law Judge