

Legal Risk Management Tip May 2018

Private Equity Valuations – Best Practices from Lessons Learned

Introduction

Private equity valuations present a unique challenge for advisers to private equity and other private funds (“PF Advisers”). Determining the market value of an illiquid portfolio company asset with no active market, and consistently arriving at a reasonable result, is challenging to say the least.

When the concepts of increased regulatory oversight and investor demand for greater transparency are added to an already complex set of considerations, the difficulties PF Advisers face with respect to this fund management and compliance overall increase exponentially.

This month’s Legal Risk Management Tip discusses select valuation topics identified in recent cases brought by the SEC’s Division of Enforcement, as well as key takeaways from those cases for direct application to PF Advisers’ compliance programs.

A. Increased Regulatory Scrutiny on Valuation

With recent increased interest in private equity and other private funds, the SEC is focused on PF Adviser’s valuation of portfolio investments. At the 2017 SEC Speaks Event, Dabney O’Riordan, the Co-Chief of the SEC’s Asset Management Unit, shared her expectation that the Asset Management Unit would continue to investigate whether private investment funds properly valued fund assets. Not surprisingly, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) issuance of the 2018 National Examination Priorities confirmed that regulatory examiners will be looking at valuations. Specifically, under the heading, “Disclosure of the Costs of Investing,” the SEC emphasized that examination staff will review fees charged based on account values to assess whether assets are valued in accordance with relevant agreements, disclosures, and an adviser’s policies and procedures.¹

B. Recent Valuation Enforcement Cases

Recent cases dealing with private investment valuation issues highlight the need for robust valuation policies and procedures (“P&Ps”) and the importance of following those P&Ps. Investors commonly request information regarding a PF Adviser’s valuation processes. In that context, a PF Adviser’s failure to follow those P&Ps after disclosing them to an investor or prospect is treated as both a disclosure failure (*i.e.*, the adviser either omitted or misstated a material fact by saying one thing, and doing another), and a policy failure (*i.e.*, the adviser either failed to customize the policy to actual policy or failed to follow its then-current P&Ps).

¹ See SEC 2018 Examination Priorities, available at: <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2018.pdf>.

Regardless of whether the conditions include aggravating circumstances, such as intentionally manipulative acts by the PF Adviser or involvement of a third party in a valuation scheme, the P&Ps play a central role in the related SEC enforcement orders.

Notably, the amount of information readily available to the SEC regarding PF Advisers managing illiquid assets is greater than ever before. Through reporting on Form PF, the SEC can easily track the amount of such investments a PF Adviser is managing, and adjust its examination prioritization accordingly.² Form PF filers report on the amount of Level 3 assets³ they manage, and larger funds are required to provide more granular details about these private, hard to value assets each year.

Key valuation issues that are at the core of recent SEC enforcement cases are summarized below.⁴

1. **In the Matter of Visium Asset Management, LP et al. (May 8, 2018)**⁵

On May 8, 2018, the SEC settled charges with private fund adviser Visium Asset Management LP (“Visium”) related to asset mismarking (and insider trading) relating to its private fund business.

The SEC’s order states that two portfolio managers of Visium falsely inflated the value of securities held by private funds it advised, thereby causing the funds to claim inflated returns, overstate values, and receive roughly \$3.15 million in excess fees.

Notably, the enforcement order includes details relating to communications with investors and prospects in which Visium described its valuation policies and procedures as establishing fair value based on U.S. Generally Accepted Accounting Principles (“GAAP”). Investors were provided with Visium’s compliance manual containing the valuation policy, while the actual valuation process followed by Visium was significantly different and not in accordance with GAAP.

² See, e.g., Division of Investment Management, Private Fund Statistics, Third Quarter 2017 (Apr. 12, 2018) (containing detailed quantitative data collected by the SEC through Form ADV and Form PF submissions, available at: <https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2017-q3.pdf>).

³ Level 3 assets are defined as those assets for which there are no observable inputs on which an advisers or the fund’s assumptions used to determine the fair value of an asset are based. (*see* Form PF, Item 14).

⁴ The cases listed focus on advisers to hedge and other funds, but the parallels and impact on valuation topics are directly relevant to the PF Advisers and the private equity sector.

⁵ In a separate settlement, Visium’s Chief Financial Officer resolved allegations that he failed to respond appropriately to red flags relating to the alleged asset mismarking. The enforcement orders are available at <https://www.sec.gov/litigation/admin/2018/33-10494.pdf>, and <https://www.sec.gov/litigation/admin/2018/ia-4910.pdf>, respectively.

Visium's settlement included disgorgement of profits of more than \$4.75 million plus interest of \$720,711, and paying a civil penalty in an amount greater than \$4.75 million.

2. In the Matter of Bradway Financial LLC et al. (July 25, 2017)⁶

On July 25, 2017, the SEC announced a settlement with a private fund adviser for, among other things, delivering statements to investors reflecting inflated values for investments in two private funds it advised.

According to the SEC, the valuation statements sent to investors stated that the fund utilized "fair market value estimates" of investments, while on occasion they also relied on third-party valuation providers to arrive at valuations, or their managing principal (who was also the Chief Compliance Officer) would frequently assign his own estimated valuations to the fund investments. To further compound issues, the adviser did not adopt or implement any compliance policies and procedures addressing the valuation of fund assets, instead opting for an "off the shelf" compliance manual that did not include a valuation policy.

The settlement order required the adviser to agree to a long list of undertakings, and pay a civil penalty in the amount of \$150,000.

3. In the Matter of Covenant Financial Services, LLC et al. (March 29, 2017)⁷

On March 29, 2017, the SEC announced an action against a private fund adviser for overvaluing municipal bonds held by its funds. The adviser used a third-party pricing service to value the municipal bonds even though the pricing service's values diverged from "fair value" under GAAP.

The adviser continued to use the pricing service's valuation notwithstanding the fact that the funds had previously sold some of the subject securities at significantly lower prices.

According to the SEC, this approach to valuation was contrary to the disclosures in the funds' written valuation policy, private placement memoranda, and other governing documents. Even though the adviser proactively took remedial steps to rebate management fees and other monies to the funds, the SEC censured the adviser and imposed a \$130,000 civil penalty plus prejudgment interest.

C. Best Practices Considerations and Key Takeaways

⁶ Available at <https://www.sec.gov/litigation/admin/2017/ia-4733.pdf>.

⁷ Available at <https://www.sec.gov/litigation/admin/2017/ia-4672.pdf>.

Clearly the above cases illustrate the PF Advisers must focus attention on their valuation protocols. PF Advisers can expect the SEC to focus on valuation issues during upcoming regulatory examinations, particularly when valuation issues continue to be a common finding. Consequently, it is of paramount importance that PF Advisers examine their valuation procedures and related compliance policies with a critical eye, keeping in mind the following best practices.

1. P&Ps should be customized and reflective of the PF Adviser's valuation operations and activities.
2. Timely communicate any significant changes made to valuation policies to current investors and prospects.
3. Consider forming a Valuation Committee, comprised of senior professionals and members of the firm to handle valuations and address issues that arise.
4. Engage qualified, experienced third-party vendors to assist with valuation efforts, which can provide objectivity in the valuation process.
5. Be engaged and seek counsel when necessary. Remember, the ultimate responsibility for ensuring accuracy and for following the steps outlined in any valuation policy lies with the PF Adviser.

For more information on how JLG can assist in evaluating your valuation practices, please contact us at (619) 298-2880.

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