

January 28, 2021

## VALUATION

# HFLR Program Explores Valuation of Illiquid Assets and Valuation Governance

By Vincent Pitaro, *Hedge Fund Law Report*

---

Valuation of illiquid or hard-to-value assets is a perennial business and compliance challenge for hedge fund managers. Because valuations have a direct impact on manager compensation; the price at which investors enter and exit a fund; and the manager's track record, valuation is also always on the SEC's radar.

A recent webinar presented by the Hedge Fund Law Report explored how assets are classified in the fair value hierarchy; common valuation challenges; valuation frequency, processes and governance; the use of valuation committees and third-party valuation agents; the impacts of the coronavirus pandemic on valuation; and the effect the impending transition away from the London Interbank Offered Rate (LIBOR) may have on valuation models. Robin L. Barton, Associate Editor of the Hedge Fund Law Report, moderated the discussion, which featured [Benjamin Kozinn](#), partner at Lowenstein Sandler, and Hugh Nelson, director in Houlihan Lokey's portfolio valuation and fund advisory business. This article presents the key takeaways from the program.

For a discussion of the SEC's concerns regarding valuation, see "[Steps Advisers Can Take to Minimize the Risk That a Routine SEC Examination Ends With a Referral to Enforcement: Five Key Priorities for OCIE \(Part One of Two\)](#)" (Jan. 4, 2018).

## Classification of Assets Under GAAP

"Fair value" under U.S. generally accepted accounting principles (GAAP) is the price at which an orderly purchase/sale would occur between market participants on the measurement date under current market conditions, Nelson said. In essence, it is the exit price for an asset. He explained that Accounting Standards Codification 820 of GAAP establishes a three-tier fair value hierarchy:

- Level 1 assets are those with unadjusted quoted prices in active markets, such as publicly traded stocks.
- Level 2 assets do not qualify as Level 1 assets but have quoted prices for similar assets in active markets or in markets that are not necessarily active. They include broadly syndicated loans quoted by several brokers; over-the-counter securities, such as mortgage-backed securities; and certain corporate and government bonds.
- Level 3 assets are the most illiquid and hardest to value. They include private company debt; leveraged loans; distressed debt; bespoke products; litigation and trade claims; and revenue-sharing agreements.

An asset's classification may change based on the availability of quotes and other market conditions, Nelson noted.

See "[Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations](#)" (May 11, 2017).

## Common Valuation Challenges

"Valuation is a process that requires both art and science," Nelson observed. The science includes understanding pricing sources and other valuation data, as well as correct application of the valuation methodology. The art entails interpretation of the information and the ability to defend judgments, which are often based on industry experience and context. Valuation conclusions should be supportable and grounded in real world experience, he advised.

See "[Three Pillars of an Effective Hedge Fund Valuation Process](#)" (Jun. 19, 2014).

Valuation issues may arise in several common situations, Nelson explained. First, quotes may become unavailable. For example, a broker may stop quoting prices for a Level 2 asset. In that event, at the next valuation, the manager would have to seek additional support for the valuation.

See "[Pricing Information Provided by Brokers to Hedge Fund Managers for Thinly Traded Securities May Not Be Reliable](#)" (Sep. 17, 2015).

Second, a manager may lack necessary expertise, Nelson continued. That may occur when a manager that previously focused on

publicly traded securities branches out into private company investments. Even if the private companies are in the same sector in which the manager has been investing, the valuation procedures will be very different.

Similarly, a manager may not have sufficient industry-specific expertise. For example, oil and gas exploration assets have specialized valuation protocols, and valuation of exchange-traded derivatives contracts is very different from off-market contracts, Nelson noted. In each case, the manager might have to update or strengthen its valuation policies or internal controls.

Market shocks can compound valuation challenges, Kozinn added. During the extreme market volatility in the first months of the coronavirus pandemic, Level 1 and Level 2 assets suddenly became much less liquid. Despite "fire sale" prices in the market – or no prices at all – managers believed the intrinsic values of certain assets were higher, he said.

See "[Valuations: Crises May Require Deviation From Usual Procedures \(Part One of Two\)](#)" (Nov. 5, 2020).

## Frequency of Valuation

Almost all hedge fund managers perform a formal monthly net asset value (NAV) calculation, even if they do not charge fees every month, Kozinn said. In private equity, some managers value assets only quarterly or annually because their assets are usually mostly Level 3.

Some hedge fund managers may acquire securities that do not trade, such as pre-initial public offering shares, Barton observed. In those instances, Kozinn explained, managers

commonly carry those securities and other Level 3 assets at cost until the occurrence of certain events, such as a new round of funding or another event that could affect the issuer's value. Purchase price is usually the best representation of an asset's value, at least at the outset of an investment.

The smaller the position size relative to the fund's total portfolio, the more likely a manager is to carry a Level 3 asset at cost until a new funding round or other event, even though outside counsel would probably advise the manager to seek a periodic third-party valuation for the asset, Kozinn noted. In addition, if a manager has carried an asset at cost for a significant period of time, the fund's auditor may push back and request a revaluation of the asset, Nelson added.

A manager that desires to increase the value of a Level 3 asset should have good support for its decision, Kozinn advised. The area is fraught with peril because management and performance fees are tied to the valuation decision. This does not necessarily mean that the manager must retain a valuation service. For example, a new funding round at a higher valuation may be a sufficient reason.

Fair value analysis does not change based on the asset's size relative to other positions, Nelson added. All valuations, regardless of position size, require a reasonable basis and support. With a larger position, however, a manager may wish to conduct additional diligence, especially after a significant amount of time has elapsed after the asset's acquisition.

Finally, although not a hard and fast rule, if Level 3 assets comprise 10 percent or more of a fund's portfolio, the fund manager should consider using a valuation firm for a year-end valuation to ensure independence, Kozinn advised.

See "[DLA Piper Hedge Fund Valuation Webinar Covers Fair Value Methodologies, Valuation Services, Valuing Illiquid Positions and Handling Valuation Inquiries During SEC Examinations](#)" (Aug. 7, 2013).

The Employee Retirement Income Security Act of 1974 (ERISA) imposes higher fiduciary duties than the Investment Advisers Act of 1940, Kozinn noted. Regardless of an asset's size, a manager has a conflict of interest in valuing plan assets. Therefore, a manager subject to ERISA should either not value the asset or seek a third-party valuation, which is best practice. The ERISA fiduciary's duty does not diminish just because a position is small, Nelson added.

## Valuation Governance and Internal Controls

Valuation policies and procedures should be tailored to the types of assets that a fund trades, Kozinn advised. The valuation policy of a fund that only trades public equities should not look the same as that of a fund that trades derivatives contracts, for example.

The policies and procedures should have clear, easy-to-follow rules for how to value each type of asset in the portfolio, continued Kozinn. For example, with respect to public equities, the policy might call for using the closing price on the primary exchange where the security trades. Similarly, for an investment-grade bond, the policy could call for obtaining quotes from three leading dealers that regularly deal in those bonds and using the middle price. The policies should include fallback valuation methods for when the primary method is not available, such as when it is not possible to obtain the requisite number of quotes, he added.

Finally, the policies should not be static, Kozinn advised. A manager should, at a minimum, review its valuation policies and procedures annually and verify that they match the portfolio's assets and practices. It should also review its policies whenever it introduces a new product or begins investing in private securities for the first time.

A manager should have an outline that provides for the classification of assets that the fund will hold, Nelson added. Policies should include procedures for pricing overrides and handling information from external sources; a description of the role of each person involved in the valuation process; and a mechanism for valuation oversight.

“Access to information is a key aspect of the whole fair value process,” Nelson explained. Inputs and assumptions used in valuation models are critical. They must be reasonable, unbiased and independent. In some SEC enforcement matters, advisers colluded with brokers to obtain favorable quotes. Therefore, controls around access to pricing information are extremely important – they help to preserve the integrity of the process.

See [“SBAI Issues Guidance on Conflicts, Valuation and Structuring for Private Credit Fund Managers and Investors \(Part Two of Two\)”](#) (Aug. 13, 2020); [“Deciphering Deer Park: Lessons for Fund Managers From a Recent SEC Valuation Settlement”](#) (Aug. 15, 2019); and [“Valuation and Cybersecurity Best Practices for Hedge Fund Managers: An Interview with Brian Guzman, Partner and General Counsel at Indus Capital Partners, LLC \(Part One of Two\)”](#) (Nov. 6, 2014).

## Valuation Committees

The size and composition of a valuation committee will depend on the size and nature of the adviser. The investment team must be part of the valuation committee because its members are intimately familiar with the fund's assets and how they are priced, Kozinn explained. Because of the investment team's inherent conflict of interest, however, its members must not be the sole members of the valuation committee. Instead, a committee will typically include:

- one or two people from the investment team;
- the comptroller, chief financial officer or other person with an accounting role;
- someone from operations; and
- someone from legal or compliance.

Larger advisers may also include someone from risk management, Kozinn added.

The valuation committee supervises the implementation of the fund's valuation policies and is ultimately responsible for determining the fair value of each asset in the portfolio, Nelson said. Typically, the valuation committee is responsible for:

- reviewing valuations, including month-end valuations;
- reviewing quotes from external pricing sources;
- documenting any [subjective inputs](#) to the process;
- addressing variances between internal and external valuations;
- [challenging valuations](#);
- reporting errors;



- approving changes in pricing sources, security valuation classifications or valuation methodology; and
- documenting the valuation process.

See “[Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees](#)” (Aug. 16, 2012).

There are no set rules for how often a valuation committee should meet, according to Kozinn. For funds that hold Level 2 and Level 3 assets, the committee probably should meet monthly. The committee of a fund that only trades public securities could probably meet quarterly or semi-annually. Generally, a fund’s valuation committee should always meet prior to the publication of the fund’s NAV, Nelson added. A committee should certainly meet at least annually. It should also review, test and approve the valuation policies at least annually.

Although a valuation committee usually does not review every line item, it should receive a comprehensive executive-level reporting package, Nelson said. A manager should be able to demonstrate and document that its valuation committee has reviewed sufficient information to enable it to carry out its duties. Generally, a committee should review:

- a summary of all fund holdings;
- all products, classified by their positions in the fair value hierarchy;
- pricing sources for each asset class;
- metrics showing gross and net market value;
- reconciliations of valuation variances, particularly between administrator and internal marks; and
- a summary of key controls, including controls over stale pricing, independent verification, conflicts of interest and changes in methodology.

See “[GLG Partners Settlement Illustrates SEC Views Regarding Valuation Controls at Hedge Fund Managers](#)” (Jan. 16, 2014).

Although it is important to record minutes of committee meetings, “over-documenting . . . can come back to bite you,” Kozinn cautioned, “because it might draw the attention of an examiner who does not understand all the nuances of the valuation process. It can get you into a rabbit hole during an exam that you could have avoided had you just stuck to high-level overview minutes of the meeting.”

At the same time, if a manager makes an exception to the valuation process that has a meaningful impact on NAV, even a change of 25 or 50 basis points, the manager should make a careful record of the reason for the exception, advised Kozinn. This will make it easier for the manager to explain its decision to regulators or investors at a later date.

See “[Valuations: Five Steps to Take When Deviating From Usual Procedure \(Part Two of Two\)](#)” (Nov. 12, 2020).

## Third-Party Valuation Agents

At times, managers may need to use third-party valuation services, Kozinn said. For example, some valuation policies provide that, when Level 3 assets exceed a specified percentage of the fund’s portfolio or exceed an absolute dollar threshold, the manager will use a valuation service to value the assets at least annually. To mitigate the conflict of interest in valuing an asset in-house and demonstrate good faith, a manager may seek a third-party valuation when there is a significant market disruption or an event that could have a material impact on a company’s value.

Some investors require managers to use valuation agents in certain situations, Nelson added. Valuation services are also useful when a manager lacks asset-specific expertise or sufficient internal resources to complete a valuation on time. Timing is critical for a manager that calculates NAV monthly, especially because valuation of certain assets can take up to several weeks. Managers should plan early to ensure timely valuations. “It wasn’t raining when Noah built the ark,” he observed. The valuation team should plan for investment and redemption cycles because defensible valuations at those times are particularly important, Kozinn added.

A manager that may need third-party valuations should establish relationships with valuation firms that have sufficient expertise in the types of assets the fund holds, Kozinn recommended. A third-party service is not needed for every asset, “but it does not hurt to have someone on speed-dial,” he advised.

When selecting a valuation agent, according to Nelson, a manager should consider:

- the firm’s asset- and industry-specific experience and expertise;
- the size, makeup and experience of the valuation team;
- the depth of its internal resources;
- whether it will provide a specific price or a range of values;
- the assumptions that it will use;
- whether the firm will interact directly with auditors and regulators; and
- its experience defending its valuations.

Different advisers have different levels of resources, Kozinn added. Some have internal experts that can help valuation services focus on specific items. Others need to be educated by the service about how to value a particular asset.

The documents that the valuation firm will need are fact-specific. When seeking a third-party valuation, Nelson said that the manager will generally have to provide:

- the legal documentation describing the investment, including the rights and privileges associated with the security;
- the underwriting model and investment thesis for the investment;
- investment committee memoranda, if available; and
- historical financial information, budgets, forecasts, historical trades in the security and prior internal valuations.

A third-party valuation does not always have to be very complex, Kozinn observed. A firm may be brought in just to conduct a simple discounted cash flow for a business.

See [“Is the Use of an Independent Valuation Firm Superior to a Manager’s Internal Valuation Process?”](#) (Apr. 23, 2015).

## Impact of Coronavirus Pandemic

The September 11, 2001, terrorist attacks and the 2008 global financial crisis both had significant impacts on valuations, Kozinn said. After the terrorist attacks, the New York Stock Exchange was completely offline for several days, making it extremely difficult for managers to value even Level 1 assets. In 2008, entire segments of the credit markets froze, and the only market prices were at “fire sale” valuations, which did not necessarily reflect fair value. Because it was impossible to value fund assets, managers had to stop calculating NAV and suspend redemptions.

See [“Mark-to-Market Accounting in the Absence of Marks”](#) (Jan. 8, 2009). See also our three-part

series on suspending withdrawal or redemption requests: “[The 2008 Crisis Versus the 2020 Pandemic](#)” (May 21, 2020); “[Key Steps in the Process](#)” (May 28, 2020); and “[When and How to Lift the Suspension](#)” (Jun. 4, 2020).

Compared with those financial crises, the effect of the coronavirus pandemic has been relatively mild, according to Kozinn. Market disruptions have been fairly short-lived. Advisers have been revisiting their valuation policies and speaking with their auditors. The markets have settled, however, and credit markets have improved. Consequently, the pandemic has not yet caused significant valuation issues.

Most valuation issues arose in March and April, when there was very little understanding of the virus and its potential impact, Nelson said. Managers were focusing primarily on portfolio triage and ensuring that portfolio companies had sufficient capital. Once it became clear that there was support from the Federal Reserve, the focus changed from triage to learning how to function in the new environment. Many managers put additional liquidity into their businesses and sought outside valuations in connection with capital infusions. Credit managers focused on what liquidity their portfolio companies needed. Valuation professionals focused on factors such as supply chains, the relevance of existing financial forecasts and the quality of new forecasts.

See “[HFLR Webinar Explores Business Issues Arising From Coronavirus Pandemic \(Part Two of Two\)](#)” (May 21, 2020); and “[How Fund Managers Can Withstand the Coronavirus Pandemic: Form ADV Filing Relief, Investor Communications and Fund Valuation Issues \(Part One of Three\)](#)” (Apr. 2, 2020).

## LIBOR Transition

LIBOR reporting is ending at the end of 2021 and will be replaced in the U.S. by the secure overnight funding rate (SOFR), which could have an impact on valuation models that now rely on LIBOR, Nelson explained. In addition, most credit documentation entered into before 2017 lacks appropriate fallback language to cover a permanent cessation of LIBOR. Those agreements and other financial contracts will have to be amended, which will “require a wholesale reorganization of the plumbing that underpins all of those agreements,” he cautioned. Firms should ensure that they have a LIBOR transition team in place and be prepared.

See “[Advisers Should Be Planning Now for the End of LIBOR](#)” (Oct. 29, 2020); and “[What Private Fund Advisers Need to Know About Transitioning Away From LIBOR](#)” (Aug. 13, 2020).