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Valuation

DLA Piper Hedge Fund Valuation Webinar Covers Fair Value Methodologies, Valuation Services, Valuing Illiquid Positions and Handling Valuation Inquiries During SEC Examinations

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By Vincent Pitaro, *Hedge Fund Law Report*

Hedge fund valuation practices are commonly misunderstood, and they are clearly subject to heightened scrutiny by the SEC. See "SEC Commissioner Aguilar Discusses Insider Trading by Hedge Fund Managers, Valuation and Other Examination and Enforcement Pressure Points," Hedge Fund Law Report, Vol. 6, No. 18 (May 2, 2013). With this in mind, a recent panel discussion hosted by international law firm DLA Piper provided a comprehensive and detailed overview of the valuation deficiencies that have been the subject of recent SEC enforcement actions; outlined valuation best practices for hedge fund managers (including "fair value" valuation methodologies, the use of third-party valuation services and valuation methodologies for illiquid positions); and detailed steps that managers should take to navigate valuation inquiries during SEC examinations.

The webcast was entitled: "SEC Enforcement and Fair Value: What Private Equity and Hedge Funds Need to Know in 2013." It was hosted by Nicolas Morgan, a litigation partner at DLA Piper and a former Assistant U.S. Attorney. Craig Beatty, Chief Financial Officer of the investment firm, Yucaipa Companies, moderated the panel. The other speakers included Michelle Keyes, an Accredited Senior Appraiser and Senior Manager at Rothstein Kass; Dan Smith, a Managing Director of ACA Compliance Group and a former SEC examiner; and Lynn Sommer, Senior Director in the Valuation Services Group at Alvarez & Marsal Valuation Services.

Current Enforcement Environment

Morgan noted that Julie M. Riewe and Marshall S. Sprung recently replaced Bruce Karpati as co-heads of the Asset Management Unit within the SEC's Division of Enforcement. See "Two New Deputies to Help Lead SEC's Hedge Fund Enforcement Unit," Hedge Fund Law Report, Vol. 5, No. 23 (Jun. 8, 2012). He expects them to continue Karpati's vigorous enforcement efforts. He observed that the number of enforcement actions brought against investment advisers has doubled since 2009 and now constitutes the largest component of the SEC's enforcement efforts. Allegations involving improper valuation practices have been implicated in many of those enforcement actions initiated against hedge fund managers. Morgan observed that that

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the SEC has commenced approximately 100 enforcement actions in the last three years against private fund managers. Numerous cases against hedge fund managers resulted from the SEC's aberrational performance inquiry, including five that involved improper valuation practices. See "Hedge Fund Managers with Unexplained Aberrational Performance Are More Likely to Become Targets of SEC Enforcement Actions," Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011). In addition, the SEC's Office of Compliance Inspections and Examinations staff have been "looking at valuation issues" during presence examinations of newly-registered advisers. See "A Roadmap and Recommendations for Hedge Fund Managers Facing Presence Examinations," Hedge Fund Law Report, Vol. 6, No. 30 (Aug. 1, 2013). Finally, whistleblower rewards available under the Dodd-Frank Act may lead to additional enforcement actions. See "How Can Hedge Fund Managers Incentivize Employees to Report Compliance Issues Internally in Light of the SEC's Whistleblower Bounty Program?," Hedge Fund Law Report, Vol. 5, No. 20 (May 17, 2012). So far, Morgan has seen two bounties awarded by the SEC pursuant to that program.

Improper Valuation Practices

Morgan outlined numerous claims that the SEC has made in recent securities fraud enforcement actions with regard to deficient valuation practices. Because it is instructive to see the full range of valuation errors that the SEC has focused on, the bullet points from the slides that accompanied Morgan's presentation are quoted here verbatim:

- Interest paid in-kind increased the carrying value of distressed debt in circumstances where recovery of principal and interest was unlikely;
- The value of underlying collateral for a portfolio investment was misrepresented;
- Asset-backed securities and structured products were valued based on models developed by management that did not adequately incorporate market-based inputs available on the measurement date (typically discount, prepayment and default rates);
- Valuations of illiquid investments were provided by consultants that were affiliated with a fund and relied on inputs obtained from the fund's portfolio managers, which resulted in valuation overstatements;
- Private equity investments were valued at cost, and an adequate fair value analysis to determine whether cost approximated fair value was not performed;
- When investments were valued using the discounted cash flow model, future estimated proceeds were not discounted to present value;
- Valuations of illiquid investments were provided by consultants that were affiliated with a fund and relied on inputs obtained from the fund's portfolio managers, which resulted in valuation overstatements;
- Private equity investments were valued at cost, and an adequate fair value analysis to determine whether cost approximated fair value was not performed;
- When investments were valued using the discounted cash flow model, future estimated proceeds were not discounted to present value.

Not surprisingly, Morgan expects government action involving hedge fund valuation practices to be initiated principally through civil enforcement actions as opposed to criminal cases. In his experience, valuation issues are not typically raised in criminal fraud proceedings because the issues are complex, involve judgment calls and may be difficult for juries to understand. One recent – and rare – exception was the criminal prosecution of Michael Balboa of Millennium

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Global, which ended in a hung jury. See "SEC Accuses Former Portfolio Manager of Hedge Fund Millennium Global Emerging Credit Fund and Broker-Dealer Accomplice of Fraud in Conspiring to Inflate the Fund's NAV," Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2011).

Sommer drew several important lessons from Morgan's list of improper valuation practices:

- Investment cost is not a proxy for fair value. An investment may not be carried at cost indefinitely. A fund must perform a standard fair value analysis "after a reasonable amount of time has elapsed."
- If a discounted cash flow model is used, it must be applied consistently, and future estimated proceeds must be discounted to present value. A firm must use the "current market participant rate."
- Values should not be "stale": A manager's policies should require regular valuations using current market data.
- A manager should consider using an independent third party valuation service to value illiquid assets and, at a minimum, should verify the accuracy of the underlying assumptions used by the third party.
- A manager must factor significant subsequent corporate events and interest that is paid in kind into the valuation of debt instruments.
- A manager must apply "standard/latest" valuation methodologies to all investments.
- A manager should have policies in place to assure that the collateral underlying structured products is valued properly.
- Policies should require models to use "market-based inputs available on the measurement date."

Sommer explained that, in short, the SEC is focused on ensuring that appropriate valuation methodologies are used and applied correctly and consistently. It will "not necessarily [take] issue with individual assumptions. . . ." She also explained that emphasis on up-to-date market-based inputs has been a "very strong theme" for the SEC.

Process and Disclosure Deficiencies

Morgan added that when the SEC does not challenge a specific valuation decision, it may claim that a firm's valuation policies are "deficient or contrary to representations made to investors." The SEC has acted on misrepresentations with respect to the frequency and documentation of valuation committee meetings, pricing procedures and use of third-party specialists. He highlighted one case that involved the directors of a mutual fund sponsored by Morgan Keegan that owned hard-to-value assets. The case was unusual because the SEC targeted the directors as well as the fund. The directors allegedly failed to adopt or maintain appropriate valuation methodologies; failed to provide guidance to the valuation committee; and failed to understand how securities were being valued or the rationales for those valuations. See "WilmerHale and Deloitte Identify Best Legal and Accounting Practices for Hedge Fund Valuation, Fees and Expenses," Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013). The directors agreed to a cease and desist order even though the SEC also claimed that the fund had actually defrauded the board.

Determining "Fair Value"

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Keyes explained that the key tenets of valuation are now provided in the Financial Accounting Standards Board's Accounting Standards Codification Topic 820, "Fair Value Measurement" (FASB Topic 820). Fair value is based on:

- Exit value;
- An "orderly transaction" between market participants on the transaction date;
- Use of the market that will yield the highest value;
- Consideration of the three primary valuation methods: income, market and cost; and
- Consideration of the transparency of the inputs.

Sommer added that the "fair value premise" is that "assets should be fair valued based on an exit price that reflects the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date." It is an "exit concept for a market participant." She identified "Policies and Procedures," "Documentation," "Rationale" and "Transparency and Consistency" as the "key themes" for fair value determinations: Policies and procedures should be written, adhered to, applied consistently and adapted as appropriate to reflect current circumstances. The rationale for assumptions should be carefully documented, as well as any deviations from those assumptions. She observed that the SEC is particularly attuned to the potential for fraud in valuation areas that "lack transparency."

Keyes summarized management's responsibilities in regard to valuations, indicating that management must:

- Assure that financial statements accurately present a firm's financial position and comply with generally accepted accounting principles;
- Use a valuation technique that is appropriate for the asset involved;
- Use "market participant assumptions";
- Document valuation decisions, including the rationale for a change in valuation method from a prior reporting period; and
- Disclose valuation methodologies and changes to those methodologies.

"Market Participant Assumptions"

Keyes said that a firm must work from the perspective of a "market participant" rather than the firm's own situation. She explained that market participants are defined as persons/entities that are independent of the parties, participate in the most favorable exit market, have access to all relevant information and are financially able and motivated to deal (but not required to do so). She added that market participants might vary depending on the life stage or size of a business, its market share and other factors. A firm's "exit market" is the "principal or most advantageous" market. A "principal" market is one that is likely to have the greatest number of bidders or volume. If there is no principal market, the "most advantageous" market is where the asset would generate the highest price. The asset's "highest and best use" must also be considered.

Third-Party Valuation Specialists

Keyes stressed that it is important to understand the scope of services that a third party valuation specialist can provide:

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- *Full scope valuation vs. limited scope valuation.* The primary difference has to do with the amount of due diligence that the third party performs and the type of report provided. In a limited scope valuation, the third party might speak to the deal team at the reporting entity but not spend much time with management of the portfolio company. A limited scope report is typically presented in summary form.
- *Positive vs. negative assurances.*
- *Exclusions.* When a third party does not assume responsibility for the reasonableness of management projections used in valuation, management must be comfortable that its projections have been reasonable over time. In determining whether discounted cash flow projections are reasonable, management should consider historical accuracy and the reasonableness of factors that affect revenue growth rates, margins, terminal growth rate and the discount rate used.

Keyes observed that, due to greater regulatory scrutiny, the industry trend is toward full-scope valuations and "positive assurance," which "provides an indication that a valuation is reasonable." Auditors and management should coordinate and try and reach consensus early on with respect to matters such as valuation methodologies, support for key assumptions and documentation of valuation.

Valuation of Illiquid Assets

Sommer provided an overview of valuation methods for equity and debt securities. She noted that the SEC has expressed concerns about the pricing of illiquid investments by alternative investment fund managers, including pricing sources, valuation models and whether there are controls in place to "identify when securities become thinly-traded." She believes that the SEC is less likely to take issue with a particular multiple or a particular rate used than with the rationale used to choose the multiple or rate. A firm's policies may adapt its valuation methods to account for specific assets, but the reasons for any such variations must be carefully documented.

Equity Securities

Sommer noted that the first step is to determine whether the equity holder has a controlling or a minority interest. Seats on a board and "club deals" may indicate control. For an *income approach* to equity valuation, a discounted cash flow is expected with respect to early-stage investments. A "market participant" rate must be used. For a *market approach*, a fund must choose "comparable companies and transactions." Choice of a multiple must be carefully documented. There should be consistency across investments and time periods. Appropriate discounts and premiums, such as for control or liquidity, should also be used. The results of the market and income analyses must be weighted, and the weighting must be documented. Finally, an equity position must be allocated across the classes of securities involved: The holder of a controlling investment can use a "current value" method. The holder of a non-controlling interest might use an "equity allocation model" or a "contingent claims analysis."

Debt Securities

According to Sommer, the first step in valuing debt securities is to determine the "unit of account." In some instances, a fund that owns both debt and equity of the same issuer may need to treat those securities as a single unit of account for valuation purposes. A holder that

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controls the issuer of the debt would usually value that debt at par, but she cautioned: "Going forward it is unclear whether this will continue to represent a best practice." When a holder does not control the issuer, there are four methodologies for valuing debt, depending on the risk of default. The first two valuation methodologies, intended for valuing performing debt, are based on market yields. The other two valuation methodologies, intended for valuing distressed debt, focus on company value.

- *Yield/income analysis.* Used when there is "adequate coverage" (i.e., ability to pay), the anticipated cash flows from the security are discounted to present value using the "appropriate market participant discount rate." The current yield of a security is determined with reference to the yields of other securities with the same credit rating. Depending on whether a recent market yield for the security is available, a "yield calibration" or "build-up" method is used.
- *Net recovery.* When a security is no longer performing fully or "may not be fully recovered under its legal terms of repayment," a holder must estimate the cash flows that the security is expected to generate and discount them to present value using the market participant rate.
- *Waterfall.* Also referred to as the "recoverability" approach, when cash flows cannot be projected at all, a holder compares the par value of debt to the actual value of the enterprise as a going concern.
- *Liquidation.* When a default or bankruptcy is likely, a holder can calculate how much the security would yield in a liquidation of the issuer. This is similar to the waterfall approach, except that the company's liquidation value is used instead of a going concern value.

Sommer observed that the SEC has expressed concern with funds that have simply used par as fair value when the yield on a bond falls within a range of yields of comparable securities. She indicated that it is important to choose a point within a range that is "most representative" of the security. If the range is too broad, further analysis might be called for. She said that it is most important to justify the point that is chosen. Sommer stressed that, for the two income-based approaches, a "market participant" rate must be used, not the contractual rate on the debt, internal rate of return or hurdle rate.

Navigating SEC Examinations

Smith commented that valuation has been one of four or five principal focus areas for the SEC during presence examinations. See "Ropes & Gray Partners Share Insights Gleaned from Successfully Navigating Presence Examinations with Hedge Fund Manager Clients," Hedge Fund Law Report, Vol. 6, No. 10 (Mar. 7, 2013). The SEC's primary concern is the conflict of interest associated with the fact that hedge fund managers typically have an incentive to overvalue assets because their compensation is tied, in large part, to the performance of the fund and its assets. The SEC also wants to assure that funds present accurate performance data to investors. During an examination, the SEC typically expects to review a fund's policies and procedures; valuation methodologies and models; and disclosures to investors. The SEC will review all of a fund's holdings and then more carefully scrutinize the documentation for selected holdings.

FASB Topic 820 requires firms to classify assets into Level 1, Level 2 or Level 3, based on a number of factors, including the transparency of pricing in a given market, how active trading is

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and the similarity of the assets to be valued to those in the market. Level 1 assets are those that can be readily and accurately priced, such as a stock that trades on the New York Stock Exchange. According to Smith, the SEC will not spend much time on valuation of Level 1 assets. For Level 2 and 3 assets, it will usually review policies, procedures and methodologies off-site and then conduct interviews with fund valuation personnel to determine whether those procedures are being followed and whether they actually "capture everything that is going on at the firm." The SEC will then select sample valuation decisions to evaluate how the policies were applied and how valuation decisions were documented. The SEC pays particularly close attention to whether there are any conflicts of interest in the valuation process and how those conflicts are addressed: The SEC is looking for independence in the valuation process and to see that steps are taken to mitigate conflicts.

Smith offered several best practices for preparing for SEC examinations:

- Because the SEC is particularly focused on documentation of valuation decisions, he recommends creating monthly or quarterly compilations of supporting data for valuation decisions with respect to all of a fund's Level 2 and Level 3 assets. Such data will "greatly expedite" SEC review.
- A manager should assure that its valuation practices actually follow its policies. Those policies should address each type of illiquid asset. Communications with investors should be consistent with those policies.
- Whenever possible, a manager should use multiple third-party valuation services.
- Policies should define the circumstances when it is permissible to change valuation methodologies. Changes should be carefully documented, as the SEC considers changes to be a potential red flag.
- The SEC prefers to see personnel other than investment personnel involved in valuation decisions. Senior personnel, such as the chief compliance officer or chief operating officer, should provide oversight. It also expects to see a valuation committee when Level 2 or Level 3 assets are involved. See "Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees," Hedge Fund Law Report, Vol. 5, No. 32 (Aug. 16, 2012).
- The rationale for any deviation from policies or methods should be carefully documented.

Smith discussed several important factors in documenting valuation decisions: First, the manager must consider the type of asset. Level 1 assets need no supporting documentation. For illiquid assets, the more closely a manager abides by its stated methodologies, the less documentation is required. If approval of a valuation committee is required, that approval should also be documented. In his experience at the SEC, he was less focused on the actual numbers than on whether there was a process that made sense; that was properly disclosed to investors; and that was properly complied with. He also considered whether there were any conflicts of interest that could have compromised the process. He observed, however, that the SEC has recently hired several valuation experts who are digging deeper into actual valuation decisions.

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