VRC

VALUE INSIGHTS

BEST PRACTICES FOR PRIVATE FUND SPONSORS IN AN AGE OF INCREASED SCRUTINY

INSIDE:

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STAKEHOLDER RELATIONSHIPS AND DEMANDS

RULES, REGULATIONS, AND GUIDES FOR PRIVATE FUNDS

As the demand for transparency rises for private investment funds, the spotlight is on valuation practices, which is essential for any fund manager to understand.

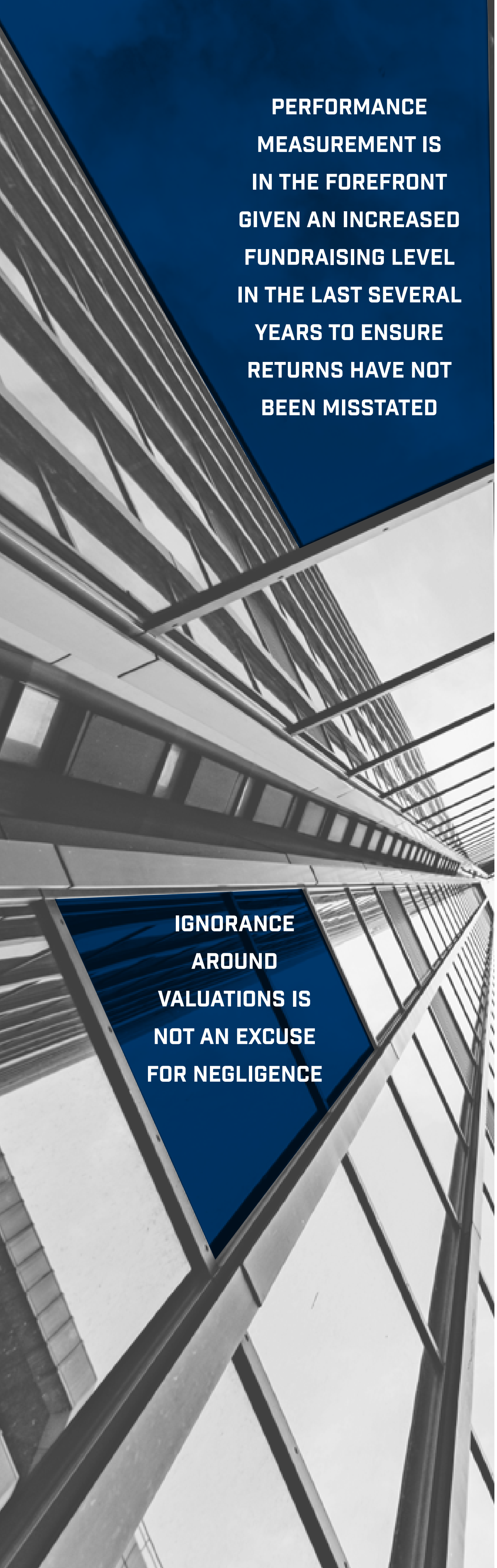
The SEC and accounting standard setters alike have set forth guidelines and requirements that private funds must adhere to regarding transparent reporting and disclosure, performance standards, and internal controls for monitoring and reporting investment values. A private equity fund, hedge fund, or private credit fund's (including BDCs, interval funds, etc.) failure to comply, failure to prepare accurate valuations of their investment holdings, and failure to maintain proper valuation policies and procedures may harm their reputation and may not withstand an SEC inquiry.

Very recently, the SEC finalized its newest rules, 2a-5 and 31a-4, clarifying how fund boards of directors can satisfy their valuation obligations and ensures that a fund's assets are properly valued. Among other provisions, the new rule 2a-5 explicitly permits the designation of fair value determination for assets that don't have market quotations to a "valuation designee" who may engage outside third parties to assist boards in fulfilling their duties. According to the SEC, the rule "establishes a principles-based framework for boards to use in creating their own specific process for making fair value determinations, including through designating and appropriately overseeing a valuation designee to perform certain valuation tasks."

The AICPA also released accounting and valuation guidelines for private funds, geared most directly to private equity and venture capital funds to estimate fair values of their investments. While the guide is non-authoritative, it harmonizes the diverse views of industry and market participants, auditors, and valuation professionals. However, best practices are not without challenges and intricacies; the guide leaves funds with a hearty basis for continued thoughtful and progressive consideration in adopting the AICPA guide's calibration concept, handling discounts and premiums, and assessing the quality of third-party price quotes used in valuation.

DEMANDS OF LP RELATIONSHIPS

The attention around valuation doesn't solely stem from enhanced regulation and updated guidelines. With more attention focused on the private markets and ever-increasing asset values, limited partners, boards, and auditors demand enhanced governance and more transparent documentation for valuations, especially illiquid investments.



LPs, many of which are institutional investors such as insurance companies, endowments, and large state and corporate pension plans, also heavily pressure general partners for increased transparency.

In the past, LPs tended to limit allocations to illiquid investments and focus more on the easier-to-value liquid investments. However, as interest rates have been historically low, LPs have had to increase allocations to illiquid investments in search of higher yields. Initially, LPs were comfortable accepting GP valuations, but as allocations grew and valuation best practices were shaped, independent valuation firms became a crucial component of financial reporting, investment performance monitoring, and assessing the basis for incentive compensation decisions.

LP's primary concerns are that erroneous valuations can lead to overpayment of management fees, an inappropriate asset allocation mix, inaccurate performance measurements, and inaccurate prices. Performance measurement is in the forefront given an increased fundraising level in the last several years to ensure returns have not been misstated. For hedge or mutual fund models, net asset value calculations need to be accurately determined frequently on a fair value basis to set prices for investors buying into or exiting respective funds.

Potential legal liabilities faced by fund managers can arise within routine operations or specific circumstances of operating an investment fund. Those liabilities that grab headlines are the ones that no manager or board cares to face. As such, the prudent fund board will involve itself in the fund valuation processes as they are ultimately responsible and accountable for the final sign-off of the asset manager's valuations. Directors are taking a greater interest in the valuation process and strive for better information regarding valuation accuracy and procedures. Indeed, there are potential legal consequences for the directors surrounding inadequate or fraudulent valuation practices. Ignorance around valuations is not an excuse for negligence.

AUDITORS UNDER PRESSURE

Since the Public Company Accounting Oversight Board's creation, auditors also find themselves under much higher scrutiny. Auditors require more detailed support of figures used in financial statements, including valuation estimates for a fund's assets, as reported under U.S. GAAP and FASB ASC 820 Fair Value Measurement. With the adoption of the Use of the Work of a Specialist, auditors often employ or engage their internal valuation specialists to obtain and evaluate audit evidence and require a higher level of diligence and documented support around asset manager valuations. Funds are finding they must spend considerable time and effort providing this necessary support to receive sign-off from their auditors on their asset values.

IMPLEMENTING BEST PRACTICES

ESTABLISHING A VALUATION POLICY

The first key component for private funds in building a transparent and appropriate best practice model is to establish a formal policy that details:

- Valuation processes and procedures,
- Establishes the principles for determining and recording fair value measurements, and
- Details the valuation techniques and procedures to be used in various situations.

This policy should be formally retained with the fund's compliance department, and if public, should be referenced in their public filings.

It is essential to formally establish employee responsibilities around the policy, obtain buy-in from all fund personnel, and follow the established policy guidelines. The policy should also be reviewed and updated as necessary periodically. The regulatory landscape is littered with examples of funds with no guidelines in place or those that may have guidelines but ultimately do not follow them.

POLICY GOVERNANCE

Once a valuation policy is created, the fund should establish a governance mechanism, which provides the framework for adequate segregation of duties and accountability. Many firms develop independent valuation committees to segregate the investment, valuation, and accounting/financial reporting functions for heightened independence.

A word of caution – if the investment and valuation committee members overlap, it creates actual biases and a perceived conflict of interest. For example, it may be difficult for an investment professional to mark down an investment they originated as they may be deeply ingrained in the original investment decision and judged on the performance of that security. A best practice creates a middle office that is responsible for determining valuations and net asset values. The middle office is also a liaison between the fund's internal audit, accounting, compliance, investment professionals, outside administrative and valuation professionals serving as fund consultants, and the fund's investors. A best practice establishes a separate valuation committee to serve as the direct link to the fund's board of directors.

In addition to independence, consistency is vital in applying the valuation policies, procedures, techniques, and methodologies, including but not limited to policies on which investments to value and how often, what methods to employ, and whether to perform the valuation internally, externally or both simultaneously.

For example, a firm may hire an independent, third-party valuation firm to perform valuations for all of their investments and then have their internal valuation committee review the results. Alternatively, they may perform internal valuation and contract an external evaluator to review those same investments; then, the valuation committee can compare results. Either way, appropriate monitoring and in-place compliance personnel should be assigned to ensure that the valuation process is carried out and consistently applied across investments and from one review period to the next.

DOCUMENTATION AND RECORDKEEPING

Based on proven financial theories and models, quality valuations require the synthesis of many variables and ultimately require a sound judgment level. In general, valuations should be:

1. Reasonably supported by observable data
2. Based on sound financial theories and rationale
3. Follow a rigorous, thoughtful process that is consistently applied and well documented

In VRC's experience, third-party reviewers of our work—such as the SEC or audit firms—are interested not only in the conclusion reached but also in observing a well-documented, standalone report that outlines observable data and provides support used to synthesize the valuation conclusion. If the analysis in review applies to a recurring valuation work product, reviewers also want to see the consistent application of valuation processes and methodologies across reports.

Scant documentation and undocumented changes in assumptions or methodologies are red flags resulting in a deeper inspection that may turn a routine exam into a disruptive interrogation.

Reviewers will often scrutinize decisions to switch assumptions or methodologies on the same investment from one period to the next. That said, recurring valuation work for asset managers and their investments is a dynamic process that must react to changes in the subject investment's fundamental performance, shifts in the market, or other new information. Such occurrences may require the valuation professional to make a change in significant assumptions or methodologies to reassess the fair value of the subject investment accurately.

Documenting both the rationale for the change and access to any new information for review is critical. The ready access to the base information used in the valuations and any further information received in subsequent reviews is part of a sound valuation documentation process.

This leads to our third best practice recommendation: firms should create a strict documentation process and a centralized repository of all the information received to support valuation conclusions.

Clients now use cloud-based services to retain information securely and serve as a centralized database for sharing information with outside vendors and constituents, such as valuation providers, investors, and auditors. Clear access to supporting documentation shows constituents that the process is organized and data is readily available for review or audit purposes. It also mitigates risk when using outside valuation agents by giving evidence that the third party has full access to all information provided to and retained by the asset manager for the valuation. Thus, no data mining is evident.

PERIODIC MONITORING

Valuation models should be thorough but flexible and provide periodic monitoring. The goal is to ensure consistent application and then document all related information.

Periodic monitoring or review is the next critical step, which can take the forms of:

- Internal look-back testing
- External compliance advice
- External mock audits

Leveraging an independent, third-party valuation firm. When establishing processes, procedures, and documentation, asset managers must remain mindful of each audience's valuation concerns:

- Investors (LPs) are primarily concerned with accuracy and transparency.
- Auditors are looking for support and insight into the rationale for your valuation decisions.
- Regulators (SEC) look for processes and documentation, consistency and comparability of valuation methods, disclosure of pricing methodologies, and unrealized performance reporting.

Communication is paramount at all steps and with all parties involved to ensure everyone understands the processes and works together, including auditors, third-party valuation firms, fund administrators, and others.

WEIGHING THE BENEFITS OF VALUATION

As pressures surrounding valuation practices increase, hedge funds and private equity sponsors need to balance their resources to the most efficient end. Hedge funds and PE firms can perform valuation work internally, but they may not have the expertise and data required. They will have to focus resources toward valuation-related work at the cost of resource allocation to investment selection and management-related work.

A third-party valuation provider can deliver an independent, objective perspective because they are not vested in the valuation conclusion. Dedicated valuation firms also have the benefit of reviewing countless securities and companies across numerous industries as opposed to the limited view of an internal team that performs a limited few annual valuations on a narrow scope of the same.

Valuation firms also often have access to databases and a proprietary data set. They also offer large, dedicated teams offering diverse experiences and when there is a gray area, can tap professionals with specific knowledge to help with critical judgment. On behalf of the hedge or PE fund, the external valuation firm will withstand questioning around derived valuations by auditors, boards, or even the SEC, rather than requiring the fund's employees to do so.

While cost is a consideration, some find quality, timeliness, and internal staff's ability to focus on their work compelling reasons to hire an outside valuation firm. The improved confidence in the disclosures can also help with investor relations, especially when considering fee-based NAV calculations or performance measurements. Independent valuation firms may also value the same or similar investments for multiple other funds, resulting in invaluable synergies and efficiencies.

But most often, the realized value is cost savings from efficiency and more effective staff utilization. Investment professionals focus on higher-margin investing. Hedge funds and private equity funds can reduce time spent on lengthy audits and reduce the potential for litigation over disputed measurements when outsourcing a cumbersome valuation process.

BEST PRACTICES CHECKLIST

To avoid unnecessary investor, auditor, or regulatory scrutiny around valuations, we recommend hedge funds and private equity funds follow several best practices to improve internal valuation processes, increase transparency, and create accountability for valuation oversight.

- [ ] Create and implement a sound valuation policy and procedures.
- [ ] Assign appropriate compliance or legal personnel to document, monitor, and update the valuation policy as necessary.
- [ ] Establish dedicated personnel or team, independent from the investment teams, to perform and monitor valuations.
- [ ] Establish documentation procedures for the ongoing valuation process, such as investment monitoring slides and repositories to store all investment and new recurring information received on the investments. This may also include a compilation of external industry or securities market data that supports the valuations.
- [ ] Develop valuation models and processes that follow industry best practices, are consistent amongst homogeneous investments, and can be replicated for subsequent periodic valuations.
- [ ] In performing valuations, consider calibration to recent transactions.
- [ ] Prepare internally or externally robust, standalone valuation reports that can withstand regulatory, investor, and auditor scrutiny.
- [ ] If an external evaluator is used, it remains essential for the asset manager to properly document its internal value corroboration to support its final fair value recommendation.
- [ ] Establish a valuation committee to periodically review and approve all valuations before sending them to the Board of Directors for final approval of fair value estimates.

CONCLUSION

Added and increasing scrutiny on valuation is here to stay. Increasingly, asset managers are getting pressure from limited partners, boards, auditors, and regulators. Establishing a formal process, creating a governance mechanism, and focusing on documentation are best practices to avoid costly regulatory issues or litigation. Bringing in an independent valuation firm can help build confidence in valuations, save staff time, and reduce cost in the long run.

ABOUT VRC

VRC is a full-service, independent, global valuation and advisory services firm. Since 1975, we have provided objective, supportable conclusions of value to both domestic and international clients.

We specialize in working with public companies, private equity firms, and private equity portfolio companies. Our core services include financial and tax reporting valuations, fairness and solvency opinions connected with mergers, acquisitions, divestitures, leveraged buyouts, recapitalizations, financings, portfolio and alternative asset valuations, and tax, compliance and planning services. VRC's in-house valuation capabilities include businesses, equity and debt securities, loans, derivative instruments, structured products, intangible assets, fixed assets, and real estate.

VRC's clients range from Fortune 500 companies to privately-held organizations. Our client roster spans a broad range of industries, allowing VRC to track and understand industry trends. We hold long-standing relationships with commercial lenders, investment banking firms, private equity firms, venture capital firms, business development companies, hedge funds, law firms, and accounting firms nationwide.

For nine consecutive years, we have been recognized by our peers and partners who have honored us as the Valuation Firm of the Year at The M&A Advisor's International M&A Awards.

We invite you to visit us at ValuationResearch.com to learn more about our capabilities, services, and professionals.