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VALUATION

Valuations: Crises May Require Deviation From Usual Procedures (Part One of Two)

By Robin L. Barton, *Hedge Fund Law Report*

The market volatility caused by the coronavirus pandemic and steps taken in response to the pandemic have, among other things, made it challenging for hedge fund managers to value certain assets. For example, closure of the Chinese financial markets from January 24, 2020, until February 3, 2020, made it impossible for managers to obtain prices for stocks traded in those markets. Other kinds of crises, such as terrorist attacks or the hacking of a third-party pricing agent, could also make it difficult for fund managers to accurately value their assets.

Ideally, a manager should have robust valuation policies and procedures that not only specify the methodology to be used to value the fund's assets but also include a contingency plan for when that methodology cannot be used – but not all policies and procedures have backup plans. In that event, what should a manager do?

This first article in a two-part series analyzes why proper valuation of a hedge fund's assets is so important, especially in the eyes of the SEC; discusses circumstances that may make valuing a fund's assets challenging; and emphasizes the need for establishing fair market value. The second article will spell out the steps that a manager without a specified contingency plan in its valuation policy should take if it must deviate from its usual valuation procedures due to a crisis.

See "Paul Hastings Attorneys Discuss Fund Governance and Management, Valuation and Line of Credit Issues Arising Out of the Coronavirus Pandemic (Part One of Two)" (Jun. 4, 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).

The Importance of Accurate Valuation

Accurate valuation of a fund's assets is important, in large part because of the role that valuation plays in calculation of the fund manager's fees.

"Valuation goes to the economics of hedge funds, in particular, as it relates to both the management and incentive fees. Because the manager is charging investors fees on the basis of its valuation, it needs a really strong process that coincides with the type of assets in which it invests," explained Benjamin Kozinn, partner at Lowenstein Sandler. "In private equity (PE), management fees are typically tied only to the amount of capital commitments, so the management fee determination and the valuation don't intersect as readily. Also, most PE sponsors don't receive their incentive fees until there is a realization event." He concluded, "Thus, we haven't seen many valuation cases in traditional PE due to the nature of those fee crystallization mechanisms."

SEC Focus on Valuation

Understandably, the SEC has been very focused on valuation issues because valuation directly affects investors in terms of the fees they pay, as well as the value of their shares in the fund.

"One of the challenges with valuation is that, in many instances, it is driving what the manager is getting paid," said Peter Wilson, managing director at Duff & Phelps and former CCO of an SEC-registered investment adviser. "Because you may be assessing your management and performance fees off of the valuation, there clearly is a potential conflict – particularly if your methodology is going to be to your pecuniary benefit."

"Valuation is a topic the SEC cares a lot about because it has an inherent conflict in it," Kozinn agreed. "A manager's compensation is tied directly to higher valuations, and investors want to make sure that assets are being valued at their fair market value."

"Another reason the SEC focuses so hard on valuation is that, ultimately, the value of the assets leads to the value of the entire portfolio, which is then reflected in the overall portfolio's performance," added Amy Lynch, founder and president of FrontLine Compliance and a former SEC examiner. "A firm that is overvaluing its holdings is going to have misleading higher performance numbers than it would have had if its assets had been properly priced. Misleading performance harms investors – and can be fraud."

"Valuation will always be a hot topic because it's at the core of a private fund: valuations drive pricing, the resulting net asset value (NAV) and the performance numbers. It all comes together to paint a picture of how well that fund is doing – or not doing," concluded Lynch. "So, yes, the SEC is always going to look at valuations. That will never change."

If anything, the pandemic has heightened the SEC's concerns about improper valuations. On August 12, 2020, the Office of Compliance Inspections and Examinations (OCIE) issued a risk alert (Alert) on compliance risks for investment advisers and broker-dealers associated with the coronavirus pandemic. According to the Alert, OCIE is concerned that firms' desire to "compensate for lost revenue" during the pandemic may increase the risk of misconduct, including overvaluation of assets.

See "OCIE Risk Alert Highlights Concerns Associated with Coronavirus Pandemic" (Sep. 10, 2020).

The SEC is not the only regulator focused on this topic – the CFTC also has its eye on valuations. For example, the SEC and CFTC both settled enforcement actions against Swapnil Rege, a portfolio manager for a hedge fund adviser, for using different valuation model inputs for similar assets to generate paper profits for one of the adviser's private funds – and unwarranted bonuses for himself. See "Manipulating Fund Valuations Can Bring Penalties From Multiple Regulators" (Sep. 5, 2019).

SEC Focus on Compliance With Policies and Procedures

The SEC is focused on whether managers not only properly value their assets but also follow their own valuation policies and procedures. Any deviations from or changes to a manager's written policy and procedures will surely raise a red flag.

"I can assure you that during any routine exam, if there is a change in your valuation approach, that is something that the SEC's staff would spend a substantial amount of time on," Wilson observed.

"The cases that we have seen over the last year have shown a lot of focus on the same issue, which is managers' not having policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 and Rule 206(4)-7," Kozinn commented. "Those cases also may be about managers not following their procedures – or knowingly following their procedures when they knew that the pricing did not represent fair market value but showed better returns for them, which generated higher fees and kept them in business."

The following are examples of enforcement actions involving failures to follow policies and procedures:

- An investment adviser provided advisory services to five registered investment companies (RICs) along with several private funds, collateralized loan obligation vehicles and managed accounts. Although the RICs' compliance policies required cross trades to be reported to, and approved by, the RICs' boards, the adviser allegedly failed to comply with those policies by not advising the boards of the cross trades. See "SEC Fines Investment Adviser for Improper Cross Trades and Principal Transactions" (Oct. 15, 2020).
- Although an investment adviser had a written policy for allocating trading costs on block trades for clients, it failed to follow that policy when the policy conflicted with restrictions on commission rates specified in individual clients' investment management agreements. See "Advisers Must Ensure Policies and Procedures Comport With Client Agreements – and Comply With Those Policies and Procedures" (Jan. 16, 2020).
- The SEC claimed that, although an investment adviser's compliance policies and procedures manual required preclearance of personal trading by employees, the adviser did not follow its preclearance procedure, which allowed a broker to engage in illegal cherry picking. See "Advisers Must Act on Red Flags to Avoid SEC Claims of Failure to Supervise" (Dec. 5, 2019).

Circumstances That May Make Valuation Challenging

The closure of the Chinese and other financial markets due to the coronavirus pandemic is one example of circumstances that can make valuing a hedge fund's assets challenging – but it is hardly unique. For example, the New York Stock Exchange and Nasdaq did not open for trading the morning of September 11, 2001, because of the terrorist attack on the World Trade Center, and they did not reopen until September 17, 2001 – the longest closure since 1933.

"With Level 1 or 2 assets, you don't really see a lot of valuation problems," said Kozinn. "If a fund is trading publicly listed equities on U.S. exchanges, there are very few things outside of a 9/11-type of event that shuts down an exchange that could have a direct impact on valuation," although he conceded that "high volatility in the markets, like we saw in March and April 2020, can create more challenging valuations."

In fact, Jennifer Press, managing director at Duff & Phelps and part of the alternative asset advisory practice, noted that because of the volatility in the markets, "in early April, we had a lot of conversations with clients about valuations."

"In my experience, those kinds of events don't happen very often, which is the good news, but sometimes a significant market disruption can occur and affect valuations," said Lynch. "We have a global pandemic that has created a huge amount of market volatility. Managers should look at the pricing of their portfolios and determine if it's accurate in light of the current circumstances and properly accounts for any significant market events."

Market volatility, however, is not a justification for overvaluing a fund's assets. For discussion of a case in which a business development company used turmoil in the financial markets as an excuse to overvalue certain debt securities, see "Three Pillars of an Effective Hedge Fund Valuation Process" (Jun. 19, 2014).

"Valuation becomes more complex with commodities and credit instruments, which can run the gamut from fairly basic investment-grade bonds of companies such as General Electric to very structured, highly complex notes or derivative-based strategies that trade on credit default swaps or other structured synthetics," explained Kozinn. "A classic example of an event affecting those kinds of assets is the collapse of Lehman Brothers, in which credit markets suddenly stopped functioning efficiently, and there weren't natural buyers and sellers of commercial and residential mortgage-backed securities." In that situation, if a manager's procedure for valuing those assets is to "get three dealer quotes, eliminate the high and the low and take the middle as the value, the manager may only be able to get one quote – if any," he noted.

For Kozinn's reflections on the tenth anniversary of the 2008 financial crisis, see our two-part series: "The Collapse and Aftermath" (Oct. 11, 2018); and "Changes to Compliance Programs, Regulation and Fund Strategies" (Nov. 8, 2018).

In addition, "hedge funds often trade in more exotic instruments with much smaller markets than the equity markets," added Kozinn. "Because the number of participants in those markets relative to the equity markets is substantially smaller, trading in those markets can become strained much more quickly and easily."

A technological issue or cybersecurity breach involving a pricing vendor can also impact fund valuations, noted Lynch. "If you have a pricing vendor whose feeds are broken because of a technological problem or a denial of service attack, you're not going to get your pricing." As an example of that, she pointed to a software glitch in August 2015 that shut down BNY Mellon's accounting system, which calculates the prices of mutual funds and exchange traded funds for its clients. The system was down for several days, delaying numerous funds' NAV calculations.

Depending on the length and timing of those kinds of events, however, their effects on fund managers' valuations may be minimal.

"Suppose a pricing feed is broken and you can't price your portfolio today, but you don't need to run your NAVs and the values of your capital accounts until quarter end. You may decide to wait if you believe you'll have prices tomorrow or the next day," Lynch posited. "If you get the pricing feed the next day, you can compare it to the last price received. Unless there were a significant market event on the day of the missing price, the delay might have no material impact on the portfolio's value."

See "How Managers Can Identify and Manage Cybersecurity Risks Posed by Third-Party Service Providers" (Jul. 27, 2017).

If it appears that the challenging circumstances will only last a few days – and they do not cross through a redemption period – the fund manager may be able to wait the crisis out, agreed Kozinn. If those circumstances stretch out for weeks or occur at quarter end, however, the manager may need to make a very difficult decision about how to value the affected assets, he cautioned.

In the end, however, it is never impossible to value any asset. After all, Press noted, "There's a whole wealth of private illiquid assets out there for which fair value is being ascribed on a regular basis. It's really just a question of thinking about how that is done without active liquid markets – but it's certainly still doable."

Establishing Fair Market Value Is Key

Fair market value is what should drive a fund manager's valuation policies and procedures, according to Press. "Assuming that the policies that are in place are rigorous and call for an estimation of fair market value, then, at a high level, there shouldn't really be a situation where a manager wouldn't be able to comply with the fair market value standards," she explained. "That's because fair value takes into account the current market conditions and how a market participant would transact at that specific moment in time. So, the policies and procedures should always allow for the determination of fair value no matter what the market conditions are."

Kozinn agreed that fair market value should be at the core of a manager's valuation policies and procedures. He defined fair market value as "how much can I sell the units I have for in a fair market, assuming an orderly sale – not fire sale prices? What's the true worth of this asset if you eliminate the chaos?"

Thus, effective valuation policies and procedures should specify the methodology and inputs to be used to value the fund's assets, as well as a fallback or failsafe plan for circumstances when those inputs are not available or the methodology otherwise cannot be used – with establishing fair market value always as the ultimate goal.

Press provided a real-world example of a hedge fund whose holdings are mainly in liquid exchange quoted instruments. "At the start of the pandemic, the manager came to us because one of the exchanges in Asia where one of its positions was quoted was closed.

Based on the manager's valuation policy, that situation triggered the manager's request for [Duff & Phelps] to perform an independent valuation," she explained. "Although the procedure in place was to take the exchange price, the policy was written in such a way where there was a failsafe. The manager still needed to establish fair value – but when that quote didn't exist, it could engage a third party to assist with the valuation."

See "Hedge Fund Valuation Pitfalls and Best Practices: An Interview With Arthur Tully, Co-Leader of Ernst & Young's Global Hedge Fund Practice," (Jan. 12, 2012).

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VALUATION

Valuations: Five Steps to Take When Deviating From Usual Procedure (Part Two of Two)

By Robin L. Barton, *Hedge Fund Law Report*

Fund managers are required not only to have policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 but also to follow their policies and procedures in the operation of their businesses. The SEC takes a dim view of managers that fail to comply with their own policies and procedures, especially those for areas vulnerable to abuse such as valuation. There may be circumstances, however, that make it difficult – if not impossible – for a manager to follow its usual valuation procedures. Unless the manager's policy has a contingency plan for when the usual valuation procedure cannot be followed, the manager must proceed cautiously – and then fill that gap in its policies.

This second article in a two-part series spells out the steps that a manager without a specified contingency plan in its valuation policy should take if it must deviate from its usual valuation procedures due to a crisis. The first article explained why proper valuation of a hedge fund's assets is so important – especially in the eyes of the SEC – discussed circumstances that may make valuing a fund's assets challenging and noted the importance of establishing fair market value.

See "Three Approaches to Valuing Fund Assets and How Auditors Review Those Valuations" (May 11, 2017); and "Three Pillars of an Effective Hedge Fund Valuation Process" (Jun. 19, 2014).

To shed light on other valuation-related issues, on November 18, 2020, at 10:00 am EST, the Hedge Fund Law Report will be hosting a webinar, entitled "How to Handle Level 2 and 3 Asset Valuation Challenges." The program will be moderated by Robin L. Barton, Associate Editor of the HFLR, and will feature Benjamin Kozinn, partner in Lowenstein Sandler's investment management practice group, and Hugh Nelson, director in Houlihan Lokey's portfolio valuation and fund advisory business. To register for the program, click here.

Step #1: Consult Valuation Policies and Procedures

When faced with circumstances that make following the usual valuation procedures difficult or even impossible, a fund manager should consult its valuation policies and procedures. Those policies and procedures should indicate what methodology and inputs should be used to value the fund's assets and, ideally, also include a failsafe for circumstances when that methodology cannot be used for whatever reasons.

If the manager has a failsafe, it should then follow that fallback plan. For example, "suppose a manager's procedure is to get three quotes from dealers it knows in the market and average them to establish fair market value," Kozinn posited. "The policy might state that if the manager can only get two quotes, then it will live with just two. But, if the manager can't get more than one quote, it will retain a third party to independently value the assets. So, that's what the manager should do."

"Unfortunately, not all firms have robust valuation policies and procedures in place," acknowledged Peter Wilson, managing director at Duff & Phelps and former CCO of an SEC-registered investment adviser. Amy Lynch, founder and president of FrontLine Compliance and a former SEC examiner, agreed that "not all valuation policies are equal, and some may not cover the types of circumstances that the firm may encounter with its portfolio." For example, "significant market events could force a manager outside of its written policies and procedures if those documents don't account for the effects of that kind of market volatility from an unforeseen event," she observed.

See "GLG Partners Settlement Illustrates SEC Views Regarding Valuation Controls at Hedge Fund Managers" (Jan. 16, 2014).

Step #2: Convene the Valuation Committee

If the manager's policies and procedures do not include a failsafe for circumstances requiring a deviation from its usual valuation procedures, best practice would be to convene the valuation committee. One reason for having a valuation committee, noted Lynch, is to address situations that are outside of the norm.

"If you don't have all of the appropriate inputs for your stated valuation methodology, certainly having a valuation committee in place to manage that valuation process is critical. In uneventful times, the valuation committee is meeting on a monthly or quarterly basis to review the models and their various inputs," Wilson remarked. "During challenging valuation times, it's ultimately the valuation committee that would consider how to value the assets and ensure the manager is establishing fair value in keeping with its fiduciary duty."

"As a matter of strong governance, even a five-person firm should absolutely consider putting in place a valuation committee, particularly if it plays in the Level 2 or Level 3 space. That committee may not be made up of 12 people like it may at some larger institutions," continued Wilson. "The simple process of having a standardized committee where minutes are being taken on a routine basis is critical, however, for defending the valuation marks that you're presenting to your auditors, investors and, ultimately, the SEC during a routine examination."

"Some valuation committees can be very small because, for example, a startup or a smaller manager may have four or five people in total. Often such firms will outsource the chief financial officer (CFO) function – and that outsourced CFO firm then serves as the valuation committee," Kozinn added. "The onus is on the manager to really understand what markets it trades in, how its assets trade in those markets and when it's time to see the valuation committee."

See "Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees" (Aug. 16, 2012).

The Role of Compliance

"First, the manager should call for a meeting of the valuation committee, making sure it has a quorum. Hopefully, the CCO is a non-voting member of the committee, so the compliance department knows what's happening," Lynch advised. "The committee should then discuss the situation and how to proceed to get the fund's assets properly valued."

"If there is going to be some substantial departure from the usual valuation procedures, certainly the recommendation would be for compliance to maintain oversight and review of what the committee decides," Wilson suggested. "The CCO can then represent to the SEC that not only was this decision made by the committee, but also that compliance played an important role in supervising these changes to ensure that they were consistent with the manager's fiduciary responsibility."

The Role of Auditors

In addition, the manager may want to involve its auditors – if not in the decision-making process, then at least advising them of the circumstances and the need to deviate from the usual valuation procedures.

"The auditors are responsible for auditing the financial statements, and the valuations are components that feed up into those financial statements. At a very basic level, they're being used to strike the net asset value (NAV)," said Jennifer Press, managing director at Duff & Phelps and part of the alternative asset advisory practice. "Managers should keep the auditors in the loop, especially when there was a deviation from valuation procedure for the reasons previously discussed."

"Auditors are there to test the efficacy of the valuation process and whether something complies with GAAP. They won't necessarily agree or disagree with the valuation itself; they will note, however, if the manager didn't follow its process for valuing the assets," Kozinn explained. "Managers should have an ongoing dialogue with their auditors – not just a once-at-the-end-of-the-year discussion, especially if the fund is in an asset class that has some potential to create more challenges with respect to valuation."

Wilson agreed that it is important to involve the auditors early if the manager must make any changes to its valuation procedures. "You should be speaking to your auditors and bouncing these issues off of them to get their feedback. If you wait for January of the following year to start tackling those issues, you've already created this mess, and cleaning it up is going to be very difficult at that point," he warned. "That's why an ongoing discussion with your auditors and other various advisers is necessary to ensure you're managing a challenging valuation situation properly."

See "Advisers Must Ensure Their Auditors Are Appropriately Competent and Capable" (Mar. 26, 2020).

Other Parties

If the valuation issue affects the core of the manager's business or the majority of the assets in which it trades or invests, Kozinn recommended that the manager discuss the situation with its board of directors. "In addition to boards, we are seeing a lot more advisory committees for onshore feeder funds. Those committees function very similarly to the board, and in fact, in hedge funds, they often have the same people as the board," he added. "In the case of a private equity fund, the manager should also be discussing the valuation issue with its limited partnership advisory committee (LPAC)."

The Decision

The valuation committee, in consultation with any experts, advisers or third parties as discussed, should decide how to proceed with valuing the fund's assets in light the circumstances.

"The valuation committee should come up with, as appropriate, an alternative for valuing the assets as it can. For example, the committee may decide to treat the assets as Level 3 assets and bring in a third-party valuation firm to value them," Kozinn said. "The whole portfolio doesn't necessarily have to be treated like that; it could be just a portion of the portfolio for which you use that outside valuation firm."

See "Is the Use of an Independent Valuation Firm Superior to a Manager's Internal Valuation Process?" (Apr. 23, 2015).

In extreme circumstances, Kozinn noted that the valuation committee may require the manager to suspend NAV calculations or redemptions if it does not believe the manager can fairly value the assets and then calculate the NAV. "That may be a pick-your-poison situation because investors are not going to be thrilled that they're either not getting a NAV statement or that they are unable to redeem because the manager can't value the assets appropriately to ensure that any redemptions would be at fair market value," he cautioned. "Those are the choices that a manager is going to have to face if it gets into a situation in which a substantial portion of its portfolio becomes illiquid or there is a circumstance that makes a real fair market value process impossible."

See 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).

Step #3: Document the Decision

As is often the case, it is crucial for the manager to document the process, including:

- what happened;
- why it prevented the manager from following its valuation procedure or methodology;
- what the valuation committee decided as to how to value the asset;
- what the reasoning for that decision was; and
- whom the manager consulted when making that decision.

"The manager should ensure that it's maintaining minutes of the valuation committee's meetings and documenting the decisions that are being made at those meetings and the work papers that are part of and substantiating the discussions that took place," Wilson advised. "It's important to have contemporaneous documentation of all of that because that's what the SEC is going to be looking for in an exam."

"Putting on my former SEC examiner's hat, I would be looking for the written minutes to that valuation committee meeting and the backup notes that support the rationale behind the alternative valuation procedure," Lynch agreed. "Having documentation in place that describes the who, what, when, why and how type of information is crucial to being able to prove to the examiners that you had a sound decision-making process."

"Obviously, the SEC is going to ask to see your valuation policies and procedures. That's going to be the first question as to valuation. Then, they're going to ask to see the minutes of the valuation committee's meetings," Kozinn concurred. "To the extent that you deviated from policy, they will probably want to see the memorandum that outlined the rationale for that deviation. When they start seeing deviations from the valuation procedures, that's when you're going to start getting a lot more questions."

"You want to control the narrative as to what you've done, why you've done it and how you've done it. When the SEC notices that you didn't follow the exact procedure, you must be able to explain why. You want to show that you tried to do the right thing," added Kozinn. "For example, if you used to get three quotes but could only get one and just took it, you need to explain why relying on that one quote made sense. For instance, maybe that dealer is the largest single dealer in that asset or security."

The SEC is also going to want to see that the manager talked to all the right people, continued Kozinn. "Did you bring in all the people that would presumably have some oversight over the governance of valuations and would protect investors: the valuation committee, the board, the LPAC, the auditors. Were those people brought into the fold?"

The SEC is not the only party that will be interested in the manager's documentation of any change in valuation procedure. The auditors will also want documentation of the decision-making process and the support for that decision, Press observed. It should be very clear that the thought process was as objective as possible and that "it wasn't as if somebody's thumb was on the scale."

See "ACA Offers Roadmap to Maintaining Books and Records: Document Retention and SEC Expectations (Part Two of Two)" (Nov. 9, 2017).

Step #4: Review and, if Necessary, Update Policies and Procedures

Managers should then update their valuation policies and procedures, if necessary, such as if a permanent change were made to the procedures. Even if the manager did not make any permanent changes, it should still review its policies and procedures to see if they should be updated to prevent similar issues in the future. For example, if the valuation policy does not have a failsafe for when the usual valuation inputs are not available, the manager should revise the policy to include language spelling out the process to be used in that event.

"If a market situation forced a temporary change in procedure, it doesn't make sense to rewrite your whole policy and procedure for when the market returns to normal," Kozinn remarked. "It does make sense, however, to ensure the policy includes some fallback options."

"Any permanent change needs to be reflected in the actual written valuation policy going forward," Lynch added. "If the change were temporary due to, say, a flash crash scenario that lasted for a brief time frame but involved severe market volatility, then you would just document the reasons for the change but not necessarily alter the policy itself."

"If circumstances have tested your valuation policy and showed that perhaps it had a flaw, weakness or gap, it should be updated accordingly," observed Press. "If Level 1 assets suddenly became Level 3 and your policy didn't address what to do in that circumstance, add a failsafe to the policy that allows for the determination of fair value no matter what based on what's known or knowable at the time and the information that's available."

"Valuation policies should have flexibility, but it's hard to cover every instance and scenario. You want to come up with some language that will address those types of circumstances in the broad sense – but not too specific for a particular pricing scenario because the next crisis might be completely different," Lynch commented. "The policy should contain a broad statement that says, 'When we do have to deviate from this policy, these are the steps we will take. For example, the valuation committee will meet to address instances that do not fall under this policy or when pricing methodologies need to be revisited.'"

Investors will also want a fund manager to have very robust valuation policies and procedures that have specificity, added Wilson. "Frankly, nowadays, during any operational due diligence by institutional investors, they're really leaning into this particular topic and exploring valuation questions with the CFO and the rest of the finance and accounting team," he observed.

In a recent speech, Dalia Blass, Director of the SEC's Division of Investment Management, observed that "[c]rises expose weak spots." Thus, a crisis may bring to light holes or issues with a fund manager's valuation policies and procedures – even if that manager did not suffer a valuation issue as a result.

See "SEC Director Discusses the Pandemic's Impact and Regulatory Developments in 2020" (Oct. 22, 2020).

"We're seeing this pandemic force firms to reanalyze their valuation processes. Even if they didn't have valuation problems, I would not be surprised to see firms enhance their valuation procedures based upon lessons learned," Wilson commented. "Firms may realize that they didn't necessarily describe in enough detail the inputs or the like that go into their valuation procedures. This pandemic shined a light on all of that."

"Of course, as a general rule, managers should be evaluating their policies and procedures across the board on a regular basis – meaning at least once a year – to make sure that their policies still fit within the type of business they're running and are tailored appropriately," Kozinn noted. Lynch concurred that making sure that the valuation policy is reviewed and updated on a regular basis is important.

See our two-part series "A Checklist for Investment Advisers to Streamline and Organize Their Annual Compliance Program Reviews": Part One (Dec. 13, 2018); and Part Two (Dec. 20, 2018).

Step #5: Notify Investors and Amend Form ADV, if Necessary

If the manager was compelled to make any material deviations from its stated valuation methodology or any material changes to its valuation policies and procedures, it may need to notify investors, as well as amend its Form ADV.

"Technically, there's no private fund pricing rule that says the manager would have to inform investors," Lynch explained. "If there were an immaterial event that caused the valuation committee to meet and determine the proper valuation methodology and the overall pricing issue did not affect the portfolio, then there is no need for extra disclosures around the event because investors were never affected by it."

"The offering documents are typically where you'd find disclosure about valuation to investors. If you depart materially from that disclosure, counsel would advise you to notify investors – and potentially seek their consent," Wilson said. "In many instances, the Form ADV, Part 2A would summarize the fund's valuation approach, so that might also need to be amended if there were a material change."

"Just because you're changing your valuation policy or the way you value a particular asset doesn't necessarily require disclosure. It could necessitate an update if the change were permanent and material and you've described in your ADV brochure how you conduct valuations, which very few do in granular detail," Kozinn explained. "If you're in or around a redemption period or a subscription time frame, then you want to give investors an explanation of what's happening because a change in valuation procedures may be material to investors' decisions as to whether to invest or submit a withdrawal request."

"It comes down to materiality. If you're talking about a $1-billion fund with a $6-million position and you need to do something different valuing that position, it's probably not material enough to either warrant a change in your public disclosures on your ADV 2A or to alert investors," continued Kozinn. "On the other hand, if the change affects all or the majority of the fund's assets or is likely to cause the NAV to decline, then you're going to want to disclose that to investors because that's a material change."

"You also have to look at what you disclosed about your valuation in your private placement memorandum (PPM). If you're now doing something different than what you said in your PPM, you have a disclosure obligation because investors are going to be making decisions based on that," added Kozinn. "Even if there is an extremely long lockup and no one can get money out, I would err on the side of caution and tell investors what you're doing and why."

See "Practical Guidance for Fund Managers on Filing Their Annual Amendments to Forms ADV" (Mar. 14, 2019).