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Valuation of Illiquid Securities as a Focus of Recent Enforcement Actions

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While the SEC consistently announces that valuation is a "key area of focus," it is uncommon for regulators to "second guess" valuation determinations in the absence of other potential violations. However, recent actions would suggest that the SEC is particularly interested in the valuations and methodologies behind illiquid securities. As we have noted here before, although valuation can be more art than science, there are heightened regulatory risks in the following areas around valuation:

(1) breakdowns in controls/policies/procedures;

(2) violations of Generally Accepted Accounting Principles (GAAP); and

(3) incomplete or inaccurate disclosures to fund investors and auditors.

The September 2018 settled action against LendingClub Asset Management (LCA) is a prime example of regulatory focus on valuation. The SEC alleged, among other things, that the manager improperly valued asset-backed securities (ABS) held by its funds. LCA disclosed that the relevant funds exclusively owned ABS backed by consumer credit loans, and that it would periodically determine a fair market value for those assets using Level 3 inputs under GAAP. As is typical for Level 3 assets, they lacked observable market inputs and were valued based on management estimates or pricing models. LCA used a discounted cash flow (DCF) model to predict the future performance of the loans discounted to present value.

However, the SEC took issue with two categories of adjustments made by LCA to the model. First, the SEC alleged that the manager improperly incorporated a “floor” for monthly returns that was not based on supportable assumptions. Second, the SEC alleged that the manager made an unjustified change to the discount rate used for its DCF model, which had the result of increasing fund returns. Although LCA later took a series of remedial measures, including outsourcing its monthly valuation to an independent third party, recalculating fund returns and reimbursing investors, the SEC ultimately determined to pursue an enforcement action against LCA and certain individuals affiliated with it.

Similarly, the SEC’s March 2017 case against hedge fund manager Covenant Financial Services illustrates a typical SEC valuation action. Here, the SEC focused on the application of an otherwise GAAP-compliant valuation policy, ultimately finding that the failure to properly apply the valuation policy (by using Level 3 inputs when Level 2 inputs were available, and inconsistent with the Level 3 inputs) resulted in violations of the anti-fraud provisions of the Investment Advisers Act.

An example of a more nuanced valuation action is that which the SEC brought against Enviso Capital in July 2017. The SEC alleged that Enviso Capital failed to use reasonable assumptions and estimation of future cash flows when preparing a DCF model, which resulted in overvaluing a loan (and consequently the fund) where it was probable that the full value would not be collected. As a result of these valuation issues, the SEC asserted that the fund’s performance was overstated and that its financial statements were not GAAP-compliant.

What does this mean? Two things: (1) valuation policies must be carefully analyzed for GAAP compliance and must be accurately disclosed to investors, and (2) valuation policies must be properly and consistently applied over time.

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