We have seen the SEC increase its focus on valuation of privately-held portfolio companies recently. The SEC's increased focus is in line with our prediction made in the Top Ten Regulatory and Litigation Risks for Private Funds in 2020 post from the start of this year, and we expect the trend to continue. The global COVID-19 crisis has added a layer of complexity to the valuation process, which for illiquid assets can be challenging during even calm economic conditions. While some companies have benefited from the changes brought on by COVID-19, the overall market conditions resulting from the crisis have led some to predict an increased likelihood of down rounds and a decrease in expected returns, potentially impacting small portfolio companies and large unicorns alike. In some cases, economic uncertainty already has taken a quantifiable toll on the businesses and prospects of portfolio companies. And the process of estimating fair value remains even more challenging because the full scope of the economic downturn remains as yet unknown. Overly optimistic valuations can lead to inflated expectations of fund investors, as well as regulatory risks if the SEC decides to take a closer look at a particular valuation.

For SEC-registered advisers, valuation will always be a key component of any exam, and disclosures to investors about valuation methodologies are always examined and compared to actual practices underlying the disclosures. For U.S. managers subject to GAAP, regulators will focus on whether the firm’s compliance policies accurately reflect the principles underlying Accounting Standards Codification 820...
The SEC has recently brought enforcement cases alleging misreported performance and misrepresentations to investors based on overvaluations. We have also seen that undervaluation of fund assets can lead to enforcement action based on the lack of appropriate controls.

The valuation of privately-held portfolio companies is a highly technical process that eludes simple explanation and one-size-fits-all advice. Fortunately, by adhering to a few basic principles, managers can increase the likelihood that a valuation will be both accurate and defensible.

1. **Managers Should Conduct Periodic Reviews of Data and Assumptions Used in Valuations.** For Level 2 and particularly Level 3 assets—that is, those that are more difficult to value due to a lack of quoted prices—identifying relevant data and assumptions is a key part of the valuation process. In rapidly-changing factual circumstances like the current COVID-19 crisis, it is important to revisit the real-life circumstances under which prior assumptions were made. Frequent reviews of relevant inputs can aid in identifying and accounting for risks in updated fair value measurements, and testing the data and assumptions can help to ensure continued accuracy.

2. **Managers Should Have Strong Internal Controls and Policies.** Regulators will assert that a valuation is only as good as the internal policies and procedures through which it was generated. However, merely establishing strong internal controls is not enough; management must ensure that those controls are followed closely. Rule 206(4)-7 of the Advisers Act (the Compliance Rule) requires the implementation of policies and procedures reasonably designed to prevent other violations, such as inaccurate disclosures to investors or excess fees based on inaccurate valuations. Where possible, the valuation process should be managed by senior back office personnel to ensure that accounting and regulatory controls are followed free from even the appearance of influence by investment personnel. Because of the underlying procedural requirements of the Compliance Rule, a failure to enact, document, and follow reasonably robust policies can lead to an independent violation, even in the absence of mismarked positions.

3. **Valuations Should Be Conducted in Accordance with Applicable Guidance.** Compliance with updated, industry-appropriate GAAP (or IASB, if applicable) is key. Consulting with auditors on complex issues is never a bad idea, but requires full and fair disclosure of all important facts. In the past, regulators have focused on the accuracy and completeness of disclosures to auditors regarding valuation assumptions and process. Those inquiries are likely to continue as regulators ramp up their focus on privately-held portfolio companies.

4. **Valuation Methodology Should Be Consistent Period-to-Period.** Consistency is important when it comes to valuations. To ensure consistency, the methodology used to prepare valuations for a portfolio company should ideally be standardized over each reporting period. This is true whether one or multiple valuation methods are used; the way in which any methodologies are employed should be consistent from period-to-period.
5. **Managers Should Clearly Document Any Changes in Valuation Methodologies.** Changes in factual circumstances, like those arising from the COVID-19 crisis, may merit a change in valuation inputs or methodologies. Best practices may require that any change in methodology should be monitored and assessed for indications of bias. Contemporaneous documentation is helpful if the change is being examined months or years after the relevant date.

Consistency and transparency underlie each of the five principles above. Problems can arise when a manager fails to follow its disclosed valuation policies, turning internal control issues into disclosure issues or potential violations of the anti-fraud provisions. Even in matters where the SEC does not challenge valuations per se, SEC staff tends to focus on structural issues around valuation, such as failure to follow firm policies and procedures or breakdowns in controls. By adhering to the principles above, managers can ensure that valuations are as accurate and defensible as possible.

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