
SEC Discusses Valuation in Proposed Rules 2022

On February 9, 2022, the Securities and Exchange Commission (“SEC”) voted to propose new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers and to protect private fund investors by increasing transparency, competition, and efficiency in the \$18-trillion marketplace.¹ The proposed rules would increase transparency by requiring registered private fund advisers to provide investors with certain information regarding performance. In addition, the proposed changes would create new requirements for private fund advisers related to fund audits and adviser-led secondary transactions.

- 1. Performance Information** - The proposed rule would require an adviser to disclose a gross internal rate of return and gross multiple of invested capital for the realized and unrealized portions of the illiquid fund’s portfolio, with the realized and unrealized performance shown separately. The value of the unrealized portion of an illiquid fund’s portfolio typically is determined by the adviser and, given the lack of readily available market values, can be challenging. For example, an adviser’s valuation policies and procedures for illiquid investments may rely on models and unobservable inputs. This creates a conflict of interest because the adviser is typically evaluated and, in certain cases, compensated based on the fund’s unrealized performance. Further, investors often decide whether to invest in a successor fund based on the predecessor fund’s performance. Utilizing an independent third-party valuation provider, such as Houlihan Capital, can mitigate these concerns.
- 2. Audit Requirements** - Private fund adviser audits would be mandatory. In addition to providing protection for the fund and its investors against the misappropriation of fund assets, the SEC believes an audit by an independent public accountant would provide an important check on the adviser’s valuation of private fund assets. Valuation is an integral part of the audit process. A fund audit includes evaluating the selection and application of valuation methods, significant assumptions, and data used by the adviser in making the estimate. Houlihan Capital works with auditors on a regular basis to provide objective, independent and defensible opinions of value that meet accounting and regulatory requirements. Our analyses and reports are transparent, supportable, and clearly outline the assumptions and projections incorporated into our financial models.
- 3. Adviser-led Secondary Transaction Requirements** – The proposed rule would require an adviser to obtain a fairness opinion in connection with certain adviser-led secondary transactions where an adviser offers fund investors the option to sell their interests in the private fund, or to exchange them for new interests in another vehicle advised by the adviser. This would provide an important check against an adviser’s conflicts of interest in structuring and leading a transaction from which it may stand to profit at the expense of private fund investors. The proposed adviser-led secondaries rule would prohibit an adviser from completing an adviser-led secondary transaction with respect to any private fund, unless the adviser distributes to investors in the private fund, prior to the closing of the transaction, a fairness opinion from an independent opinion provider and a summary of

¹ <https://www.sec.gov/rules/proposed/2022/ia-5955.pdf>

any material business relationships the adviser or any of its related persons has, or has had within the past two years, with the independent opinion provider. This process would provide an important market check for private fund investors by providing some assurance that the price being offered is based on an underlying valuation that falls within a range of reasonableness. Houlihan Capital is a premier provider of, and thought leader on, fairness opinions, including for adviser-led secondary transactions. See www.fairnessopinion.com for more information.

Houlihan Capital is here to help private fund advisers follow best practices. As an independent valuation firm, we pride ourselves on providing senior-level, superior quality client service at competitive prices.

For more information and valuation assistance, please contact:

Michael Norton
Director, Business Development
mnorton@houlihancapital.com
(312) 450-8628