Valuing The Invaluable

Law360, New York (March 06, 2012, 12:48 PM ET) -- “I think that private equity law enforcement today is where hedge fund law enforcement was five or six years ago.” This recent quote by Robert Kaplan, co-chief of the Asset Management Unit of the U.S. Securities and Exchange Commission’s Division of Enforcement, should be a wake up call to the private equity community that the SEC is coming.

The statistics are staggering. Since 2000, the SEC has brought only 12 cases against managers of private equity funds, whereas in 2011 alone, the SEC brought 50 cases against hedge fund managers. In a number of statements over the last few months, various members of the SEC’s staff have made clear that private equity is in the SEC’s crosshairs. While the SEC has been, and continues to be, keenly focused on hedge fund managers, it is undeniably apparent that private equity fund managers are now also the SEC’s focus.

By March 30, 2012, private equity fund managers in the U.S. that have at least $150 million in assets under management, and do not otherwise come within a severely limited set of exemptions under the Investment Advisers Act of 1940 as amended by Dodd-Frank, will be required to be registered with the SEC as investment advisers under the Advisers Act. Registration will subject those managers to significantly increased disclosure requirements, SEC scrutiny and potentially intrusive rules, and will give the SEC and its staff a ringside view into private equity for which the SEC has lobbied over the past few years.

Many of the most high-profile cases recently brought against hedge fund managers have been related to insider trading. The SEC has indicated that insider trading rules can be breached with respect to securities that are not publicly traded, but the great majority of the SEC’s insider trading cases have involved publicly traded instruments. Unlike hedge fund managers, private equity fund managers do not spend much time or resources trading in public markets. Since the mandate of most private equity funds is the investment in, and/or the acquisition of private companies and securities, insider trading in public markets based on material nonpublic information is less of a risk for private equity fund managers.

So on what is the SEC and its staff really going to focus as it delves more deeply into the private equity world? One answer seems to be conflicts of interest presented by the valuation of hard to value illiquid securities. As reported by Bloomberg News, at the end of last year, the SEC sent a 16-page letter to a number of private equity fund managers asking, in particular, about portfolio investment valuations.
Little immediate economic incentive would seem to exist for most private equity fund managers to inflate the valuations of their portfolio companies because they are not typically paid on the basis of internal valuations. Most private equity fund managers earn their management fees (typically 1.5-2 percent) on committed and invested capital and may be entitled to carried interest (typically 15-20 percent) on portfolio company realization events (such as a sale or IPO of a portfolio company).

When raising new funds, however, private equity fund managers do typically disclose the internal valuations of their portfolio investments. Most private equity funds also provide their investors with quarterly updates on the performance of the portfolios which typically includes the current internal valuation of all portfolio investments then held by the funds. The incentive can exist, therefore, for private equity fund managers to inflate their own internal valuations in seeking to attract investors or to highlight to current investors the strong performance of the “fund.”

Since private equity funds, by definition, invest in private illiquid securities, it is, however, difficult to objectively gauge valuation by then existing public market trading data. No publicly quoted market prices are generally available for the bulk of private equity fund portfolio investments. A recent high-profile example demonstrates how difficult it is to value equity securities that are not publicly traded even when ample public information is available about the company.

On Feb. 1, 2012, Facebook filed its Form S-1 Registration Statement with the SEC disclosing an abundance of once highly confidential financial and performance information. Since then, a great deal of public speculation has appeared as to Facebook’s value. Self-proclaimed analysts and business reporters have claimed that Facebook is “worth” $50 billion to over $100 billion. Who is right? The answer is that no one knows and all the speculation in the media is simply a series of guesses. Until Facebook’s IPO is priced and its shares trade on a public exchange, no one will really know what it is worth on a day-to-day or minute-by-minute basis.

Prior to November 2007, private equity and venture capital funds reported the value of their illiquid portfolio investments at initial cost in lieu of other extraordinary external valuation factors. In November 2007 mark-to-market accounting was made applicable to these funds so private equity fund managers were required to value such investments at “fair value” prior to a liquidity event for the security.

Under Financial Accounting Standards Board Statement No. 157, fair value is broadly defined as what a third-party buyer would pay for the asset in a typical sale transaction that is not a fire sale. When public market trading data is readily available, fair value is easy to ascertain and objective. When, as is the case with the bulk of private equity investments prior to liquidity, no public trading market for the securities exists, the private equity fund manager has latitude as to the current value or “mark” of the investment.

Fair value accounting requires managers to take into account all relevant factors material to the value of the asset. Discounted cash flow, market comparables, revenue multiples and similar metrics are regularly used in fair value analysis. Extrinsic factors such as third-party offers or valuations can also be important. Assuming good faith and an honest desire to get it right, the question is, however, which of these factors should always be incorporated into the analysis and which should be discounted?

For instance, does a private equity fund manager need to take into account third-party offers for the asset that the manager knows are not serious or well below market? Should the manager discount third-party valuations solicited by a portfolio company’s management and potentially "guided" higher or lower depending on management’s own compensation and/or tax needs?
These and other similar questions are central to how private equity fund managers regularly value their portfolios. Fair value accounting provides only broad guidance and the SEC's own particular views are not, and may never be, objectively clear on these points. In lieu of such guidance and again, assuming good faith and an honest desire by the managers to get to the right answers, a potential solution is for a private equity fund manager to have well established and thoughtful written valuation policies and procedures that are regularly reviewed and updated by a committee of senior management that is intimately familiar with the fund’s portfolio and the applicable marketplace.

This "valuation" committee should meet on a regular basis and vigorously review and analyze the marks of each investment in the portfolio taking into account all of the factors set out in the valuation policy. The valuation committee also should regularly review, test and update the valuation policies and procedures themselves to seek to ensure that they are consistent with market trends and best industry practices to the extent those are identifiable. Failure to take heed of this emerging brave new world of regulatory oversight of, and concern with, the potential conflicts of interest inherent to private equity valuations can and will invite a whirlwind of trouble for private equity fund managers in the future.

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