Valuing Illiquid (Level 3) Investments

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Program level : Basic

No prerequisites are required

No advance preparation is required

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About

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Introduction

Regulatory Expectations:

- Fiduciary Obligations
- Regulatory Risks
- Compliance Controls
- Recent Regulatory Enforcement

Valuation Practices:

- Primary valuation approaches
- Inputs and the Fair Value Hierarchy
- Valuation considerations in the current market
- Best practices and challenges in valuation engagement

Regulatory Expectations

1- Regulatory Expectations

A- Fiduciary Obligations

In 2025, the core fiduciary duty of investment managers to act in the best interests of their clients remains firmly grounded in the Investment Advisers Act of 1940. However, increased regulatory scrutiny and evolving market complexities have further emphasized the need for transparent and robust valuation practices—especially when asset values are not readily observable. The SEC continues to reinforce its expectations through extensive guidance, underscoring that accurate and defensible valuation processes are central to fulfilling fiduciary responsibilities.

B- Regulatory Risks

Valuation remains a critical component of fair value reporting, directly impacting the calculation of net asset value (NAV), and by extension, management and performance fees. Key risks investment managers must address include:

- Inaccurate valuations leading to misinformed investor decisions.
- Overpayment or underpayment by new investors entering a fund, creating potential inequities.
- Redeeming investors receiving more or less than the true value of their holdings, which may disadvantage remaining investors.
- Potential conflicts of interest where portfolio managers may seek to influence valuations for personal or performance-related gain.

Regulatory Expectations

C- Compliance Controls

1) Key Valuation Policies and Procedures Considerations
   - P&Ps should be drafted to promote fairness and consistency in the valuation process
   - P&Ps should clearly indicate the methods, principles and models that will use to value investments
   - P&Ps are meant to be living documents. They should be reviewed at least annually and at any time that there are changes in your Firm’s practices.

2) Valuation Committees and other Governance Considerations

Many firms will have valuation committees to ensure that no one person has oversight and control of valuations and there is a consensus in situations in which there is discretion on the part of the manager. Regardless of whether Valuation Committees, Fund Boards, or the manager itself, there are several topics for which the SEC staff would expect a governing body to take responsibility for:

- Approve specific policies and procedures
- Identify circumstances requiring fair value
- Determine methodology (ies) and Resolve / avoid conflicts of interest
- Maintain oversight of the valuation process (if delegated)
- Ensure all appropriate factors considered
- Assess the appropriate methodology for determining the value of each security

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D- Regulatory Enforcement Actions

- SEC Signals Concerns Over Private Credit ETF Liquidity & ValuationIn February 2025, the SEC publicly raised concerns about the **SPDR SSGA Apollo IG Public & Private Credit ETF**—a newly launched ETF offering exposure to private credit. The regulator highlighted serious issues with liquidity and valuation compliance, noting the ETF could hold up to 35% illiquid assets—well above the 15% cap for registered funds. The SEC even requested removal of "Apollo" from the fund's name due to potential misrepresentation of liquidity capabilities

POLLING QUESTION

Which of the following is a potential risk arising from inaccurate valuations in investment funds?

a) Increased liquidity for all investors

b) Overpayment or underpayment by new investors entering the fund

c) Guaranteed higher management fees

Valuation Practices

A- Background

Definition of Fair Value

- Fair Value in accordance with FASB Accounting Standards Classification Topic 820
- Defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”
- Fair value is an exit price vs. entry price
- Fair value is a market-based measurement (assuming change of control), not an entity-specific measurement
- Assumes a transaction in the principal market, or, alternatively, the most advantageous market
- Fair value measurement is made up of one or more inputs based on market participant assumptions
- Inputs form the basis of the fair value hierarchy Significant and detailed disclosures are required for securities that are classified as each of Level 1, 2,and 3 (per the fair value hierarchy

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B. Discerning between Level 1, Level 2, Level 3 (Fair Valuation Hierarchy)

Fair Value Hierarchy

- Identifies the assumptions that a representative market participant would use to price an asset or liability, including an adjustment for risk whenever a market participant would include such an adjustment to price the asset or liability
- Establishes a fair value hierarchy that prioritizes the inputs used to measure fair value into three broad levels, considering the relative reliability of the inputs
  1. **Level 1 Inputs** – quoted (unadjusted) prices in active markets for identical assets or liabilities, where the reporting entity has the ability to access these markets for a potential transaction at the measurement date
  2. **Level 2 Inputs** – inputs that are observable, either directly or indirectly as of the measurement date, other than quoted prices included within Level 1
  3. **Level 3 Inputs** – unobservable inputs (unobservable inputs may be used to measure fair value to the extent that observable inputs are not available)
- In practice, when valuing holdings other than publicly traded stock or debt (or other assets traded on active public markets) the valuation inputs will typically include Level 3 inputs, such as required rates of return, pricing multiples, fair yields, or management provided projections or estimates, resulting in a Level 3 conclusion of value

Level 1 - Market to Market

ASC 820 requires:

Positions must be marked to market (e.g., carrying values on balance sheets adjusted) using the fair value standard – Can not be held at lower of cost or impaired value Unadjusted quoted prices from an exchange or broker-dealer market that is deemed to be active Need to have a consistent approach as to how the quoted price is used

- Quoted prices should not be adjusted because of the size of the position relative to trading volume (i.e., blockage discount)
- Bid (long positions) quotes are preferred, given the exit price concept
- If any significant adjustments are made to quoted prices, these become Level 2 assets

Level 2 - Mark to Matrix

- Observable inputs: quoted prices for similar assets in active markets
- Broker quotes: if the trade can be executed at that price (may require more than one or
- two quotes)
- Quoted prices for identical or similar assets in inactive markets (a blockage discount may be appropriate)
- Other observable market inputs: interest rates, yield curves, volatility factors, credit risks
- Inputs derived from or corroborated by observable market data through correlation or
- regression analysis
- For Level 2 designations, any models used must be widely accepted and non-proprietary, and the data used must be observable
- If any significant adjustments are made to Level 2 Inputs, they generally become Level 3 assets

Level 3 - Mark to Model

- Unobservable inputs (e.g. required rates of return, pricing multiples, fair yields)
- Models (e.g., Black-Scholes, discounted cash flow, multiple of earnings or EBITDA) utilizing significant inputs that are unobservable
- May include publicly listed securities with very little market activity
- Reflects the entity's own data about the valuation assumptions that market participants would use
- Cannot ignore reasonably available information without undue cost and effort to market participants

POLLING QUESTION

Under ASC 820, when do Level 2 inputs generally become Level 3 assets?

a) When significant adjustments are made to the Level 2 inputs

b) When they are derived from broker quotes.

c) When they include observable market inputs such as yield curves.

Primary Valuation Methodologies

Market Approach:

- Comparable Company Market Multiples (e.g., EV/Revenue, Price/Book)
- Comparable Transaction (same as above, but based on control acquisitions)
- Previous Transaction in Subject Co.'s Stock / Last Investment Round
- Firm Offer

Income Approach:

- Discounted Cash Flow
- Capitalization of earnings

Cost Approach:

- Investment Cost
- Cost to build
- Replacement Cost

Methodology Considerations

Methodologies should consider a variety of factors, such as:

- sources of prices
- priority of sources
- how the sources are used

Methodologies should generally include, as applicable:

- readily available quotes (for exchange traded securities)
- broker-dealer quotes
- third-party pricing services
- proprietary pricing models
- original cost of investment, etc.

Best Practices in Valuation Engagements

- Comply with Fair Value Measurement Framework (ASC 820 / IFRS 13)
- Apply guidance from AICPA PE/VC Valuation Guide and IPEV Valuation Guidelines
- Maximize use of observable market inputs (Level 1 & Level 2)
- Calibrate valuation models at inception and regularly thereafter
- Use multiple valuation methods, when applicable
- Maintain internal consistency across assumptions and methods
- Ensure robust documentation and audit trails for all valuations
- Engage third-party valuation specialists when complexity or materiality warrants independent validation
- Align valuations with regulatory expectations and investor transparency standards

POLLING QUESTION

When valuing an investment, which guideline emphasizes maximizing the use of observable market inputs (Level 1 & Level 2)?

a) ASC 820 / IFRS 13

b) Cost Approach Framework

c) Proprietary Pricing Models

Valuation Challenges & 3rd Party Vendors

There are certain **Valuation Challenges** in prior and current environment as follows

- Volatility between measurement periods
- Inflation and rising costs
- Aggressive forecasts
- Limitations on available data or information
- Disagreements with Auditors and/or Independent Valuation Specialists

Use of third part vendors is very common and below is a list of a few

- Independent
- Expertise in asset class & industry
- Experience interacting with auditors, regulators, investors, administrators
- Ability to support valuation analyses and conclusions
- Team capacity to meet volume and timing needs
- Resources to access market information

POLLING QUESTION

Which of the following best reflects the overall best practice in performing valuations under the Fair Value Measurement Framework?

a) Use only one method to keep it simple.

b) Apply multiple methods, use market inputs, calibrate models, and keep strong documentation.

c) Rely only on proprietary models without market or third-party data.

THANKS FOR LISTENING

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