

Inigo Montoya Explains Fair Value Transactions with Affiliated Funds

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Background

In the film, *The Princess Bride*, Vizzini repeatedly describes the Man in Black's climb up the cliff as "inconceivable," despite the fact that the latter continues his climb. Inigo Montoya finally responds, "You keep using that word. I do not think it means what you think it means."

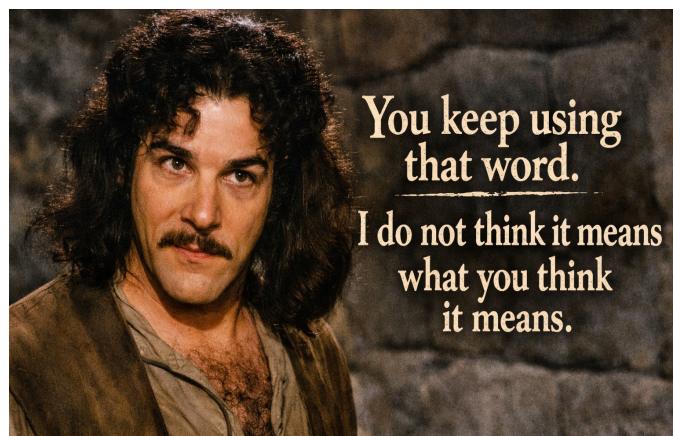
The Facts of the Case

This past February, the SEC sanctioned a Registered Investment Adviser (RIA) for deficient valuation practices concerning affiliated principal transactions with the private funds the RIA advised during the COVID-19 pandemic and concomitant market dislocation. The adviser originated senior secured loans through its parent company for sponsor-backed lower-middle-market acquisitions and subsequently sold portions of those loans to affiliated funds after a short seasoning period, typically 30 to 60 days.

The firm's fund governing documents and investor disclosures stated that these transactions would occur at "fair value" on terms no less favorable than those available in a comparable arm's-length transaction, and that pricing would be reasonably determined by the adviser *without any third-party valuation*, subject to review-agent consent on behalf of the funds.

The Funds' advisory agreements and disclosures to investors stated that the adviser would sell the loans to the affiliated funds at "fair value" or "fair market value" after an independent review agent provided consent to the sales on behalf of the funds. In practice, however, the adviser used a mechanical pricing convention to execute transactions at par (less unamortized original issue discount) based upon the assumption that recently originated performing loans retained their original transaction value.

Over the relevant period, the adviser executed almost 150 such sales to affiliated funds without adjusting prices to reflect contemporaneous market conditions, while representing to the funds' review agent that the transaction prices reflected fair value. Had Inigo Montoya been the SEC examiner, he could have pointed out regarding the adviser's representations of *fair value*, "I do not think those words mean what you think they mean."



The SEC found that the adviser applied this methodology during the pandemic-driven market disruption without undertaking a meaningful reassessment of the impact of market conditions on loan values, which of course declined as credit spreads widened on the funds' transaction-backed loans. Although the adviser confirmed that the loans maintained a minimal internal credit rating before sale, **it did not perform broader market-based valuation analyses despite clear evidence of generalized downward price pressure and borrower-specific operating stress in certain credits.**

The SEC concluded that the adviser failed to satisfy its fiduciary and disclosure obligations in conflict-laden principal transactions and thereby willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8. In response to the SEC's deficiency letter, the adviser reimbursed the affected funds (plus interest), agreed to pay a substantial civil monetary penalty, and voluntarily enhanced its loan transfer practices. The review agent was not sanctioned, but it is not clear what value-add they provided.

The Take-aways

Credit analyses in a vacuum without considering market dynamics and market participant pricing is deficient and can lead to unfair outcomes to fund investors.

Conducting affiliated transactions without third-party valuation review can be dangerous and expensive (both monetarily and to one's reputation). Also, rubber stamp reviews do not offer protection.

Recent concerns over "stale" valuations due to volatile market conditions and souring credit outlooks in tandem with restricted liquidity and slowed redemption show that the "fair value v. par" pricing issue persists for private credit funds (and is not just limited to Black Swan events like Covid-19).

It should be inconceivable that loan valuations would not be affected by dramatic changes in market conditions. When determining fair value, it is better to be Inigo Montoya than Vizzini.

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