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VALUATION PRACTICES FOR REGISTERED INVESTMENT COMPANIES HOLDING PRIVATE AND HARD-TO-VALUE ASSETS

Registered investment companies are increasingly investing in private, illiquid, and bespoke assets that do not have readily available market prices and therefore can present heightened valuation challenges. In this article, the authors review the statutory and regulatory framework for fair valuation of assets under the Investment Company Act of 1940, discuss related accounting, governance and disclosure practices, and comment on recent areas of focus for Securities and Exchange Commission (“SEC”) examinations of registered investment companies relevant to valuation.

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Registered investment companies are increasingly investing in private, illiquid, and bespoke assets that do not have readily available market prices. Interval funds, tender offer funds, business development companies, and certain mutual funds and exchange-traded funds hold private credit, venture and private equity, structured instruments, and other assets for which observable market inputs are limited or unavailable. While these investments may offer diversification and the potential for enhanced returns — and respond to rising demand for asset class exposures beyond traditional equity and fixed income — they also present heightened valuation challenges.

Valuation, meanwhile, is central to the entire operating construct of a registered investment company.

- Net asset value (“NAV”), the sum of the value of a fund’s assets less the sum of the value of its liabilities, is the basis for determining the value of investor holdings, advisory fees, and other core purposes.
- NAV per share — often determined daily — establishes the price at which a fund will issue new

shares and redeem or repurchase shares being tendered back to the fund by exiting investors. Accuracy for this purpose is critical to fairness to investors. If NAV per share is overstated, purchasers of new shares overpay for their shares, and redeemers receive a windfall at the expense of remaining shareholders. If NAV per share is understated, the opposite is true. Purchasers of new shares buy at a discount (diluting the existing shareholders) and redeemers receive less than their fair share.

- NAV is the basis for reporting a fund’s investment performance.
- NAV is the customary basis for calculating fees owed by the fund to its investment adviser and other service providers.
- NAV is a necessary input when calculating fund-level risk and compliance metrics, such as diversification, or concentration, or leverage ratios.

As should be clear, unreliable valuations can lead to potentially serious compliance and operational failures

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