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Investment Funds | Securities Enforcement Update

March 3, 2026

Seller Beware: SEC Enforcement Action Highlights Challenges of Principal Transaction Pricing in Periods of Market Dislocation

The SEC enforcement action highlights the agency's continuing scrutiny of valuation practices and disclosures by private fund sponsors of illiquid investments.

The Securities and Exchange Commission (the SEC) recently announced a settled enforcement action that highlights the agency's continuing scrutiny of valuation practices and disclosures by private fund sponsors of illiquid investments. On February 25, 2026, the SEC settled claims against a formerly registered investment adviser and private fund manager (the Adviser) concerning the sufficiency of established fair valuation procedures for principal sales of loans to private fund clients (the Funds) during a brief period of extreme market dislocation at the beginning of the pandemic. Without admitting or denying the SEC's allegations, the Adviser agreed to settle to negligence-based violations and a \$900,000 penalty.^[1]

Key Takeaways:

- During periods of unusual market volatility, the Commission expects advisers to consider the potential need to go beyond established valuation procedures to validate fair value for principal and other related-party transactions.

- Notwithstanding recent speeches by senior leadership, the Enforcement Division and the Commission appear willing to pursue rather technical, time-limited, historic issues, in spite of a registrant's remediation in response to examination findings.

The SEC Order:

According to the SEC's [Order](#), the Adviser, based in Chicago, originated certain senior loans using proprietary capital, typically held the loans for 30–60 days, then sold portions of such loans to the Funds. The advisory agreements with the Funds and the private placement memoranda stated that the Adviser would sell loans to the Funds at “fair value” or “fair market value” as reasonably determined by the Adviser without any third party valuation and on terms “no less favorable to [the Funds] as the terms [they] would obtain in a comparable arm's length transaction with a non-Affiliate.”

The Order outlines the key components of the Adviser's valuation policy and practice:

- The Adviser's written valuation policy provided that loans sold to the Funds would be transferred at the Adviser's purchase price, less the unamortized loan fee or discount at the time of transfer, “subject to market adjustments that may be made in [the Adviser's] sole discretion.”
- In practice, the Adviser sold loans to the Funds at par value less the unamortized loan fee, based on the belief that the closing price of the loan generally represented the fair market value given the limited time period between origination and the sale to the Funds.
- The Adviser followed an internal credit rating system to assign a rating to each loan it underwrote, and only sold to the Funds loans rated “B” or above at the time of sale.
- The Adviser sought to comply with the client consent requirement of Section 206(3) of the Investment Advisers Act of 1940 (the Advisers Act) for principal transactions by having a third-party agent for the Funds review the proposed transaction and consent to the sales.^[2]
- In requesting the agent's consent, the Adviser certified to the agent that the loan sale was being conducted on an arm's length basis, consistent with its advisory agreement, and that based on current market conditions, the Adviser believed the sale to be at fair market value.

The loan sales at issue in the SEC's Order occurred during a very narrow time period at the beginning of the coronavirus pandemic: March 2020 through May 2020. During this period, the Adviser sold portions of loans to the Funds that it had originated before the start of the pandemic at par value less the unamortized loan fee, consistent with the written valuation policy and prior practice. According to the Order, in light of the unusual market conditions, the Adviser should have done more to confirm that loans were being sold at fair value: “between March 2020 and May 2020, at the start of the coronavirus pandemic, during a period of disruption in U.S. financial markets, [the Adviser] continued to sell performing loans it originated before the market disruption at par value less the unamortized loan fee and *failed to determine the effect of the market disruption on the fair market value of those loans.*”

The order also notes a number of mitigating facts. First, all but one of the loans at issue either continued to perform or were fully repaid by the borrowers. Second, in May 2021, in response to an examination deficiency letter concerning this activity, the Adviser voluntarily reimbursed the Funds over \$5 million and made enhancements to its disclosures and policies regarding its loan transfer practices.

To settle the matter, the Adviser agreed, without admitting or denying, to negligence-based violations of Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-8, and to pay a \$900,000 penalty.

The Bottom Line:

This action reflects continued regulatory scrutiny by the SEC's Divisions of Examinations and Enforcement of valuation practices and compliance with related disclosures by private fund sponsors of illiquid investments (as discussed further in previous Gibson Dunn alerts [here](#) and [here](#)), particularly in affiliated transactions, and should be of interest to sponsors that warehouse investments on their own account or at a fund with the intent to transfer to a parallel or co-investment vehicle, sponsor continuation funds, lead secondary transactions, pursue a "season and sell" credit strategy, or otherwise engage in principal and other related-party transactions across funds, among other activities. **Even where consent is obtained and the subject investment ultimately performs to expectations, the SEC signals an expectation for contemporaneous evidence that affiliate transaction pricing reflects current market conditions rather than defaulting to adjusted cost without further consideration, with a particular focus on sales occurring during a period of market distress or volatility.**

[1] *In Re: Madison Capital Funding LLC*, Advisers Act Release No. 6948 (February 25, 2026), available at <https://www.sec.gov/files/litigation/admin/2026/ia-6948.pdf>.

[2] Although the SEC's Order states that the Adviser's sales to the Funds were principal transactions subject to Section 206(3) of the Advisers Act, the Order does not analyze whether the loans constitute "securities."

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