MORRISON | FOERSTER

Client Alert.

January 2, 2013

SEC Accuses Fund Directors of Breaching Their Valuation Duties

By Kelley A. Howes

In a case involving fair valuation of structured notes, the SEC signaled that when investment company fund boards delegate the responsibility to fair value portfolio securities, they must provide "meaningful substantive guidance" and continuously review the appropriateness of valuation methodologies.

On December 10, 2012, the Commission announced charges against eight former members of the board of directors of several closed-end and open-end registered investment companies. The Commission alleges that the directors failed to properly fair value a majority of the funds' portfolio holdings from January 2007 until August 2007. The funds' investment adviser settled charges in 2011 based on the same set of facts.

The case is noteworthy for the specificity of the allegations against the board members, and provides insight into how the SEC's enforcement division will pursue cases against fund directors in the future. Also, the form and substance of the allegations may broadly affect how fund directors carry out their fair valuation responsibilities.

The securities. The funds invested a majority of their total assets in complex debt securities known as structured products, including collateralized debt instruments. A significant number of the structured products were subordinated tranches of various securitizations for which market quotations were not readily available.

The procedures. The SEC said that the funds' policy and procedure manual delegated to the investment adviser the responsibility to carry out functions related to the valuation of portfolio securities. The valuation procedures called for the funds to apply current market values when market quotations were readily available. When market quotations were not readily available, the funds were to apply fair value as determined in accordance with the funds' valuation procedures.

The valuation procedures require the funds to apply fair value as determined in good faith by the adviser's valuation committee (rather than as determined by the board of directors). The procedures listed general and specific factors to be considered. The SEC noted that the factors "were copied nearly verbatim" from the SEC's Account Release Series 118. According to the SEC, the valuation procedures:

- provided no meaningful methodology or other specific direction on how to make a fair value determination for specific portfolio assets;
- provided no guidance on how the listed factors should be interpreted or weighted;
- did not specify what valuation methodology should be employed for each type of security;
- did not specify how to evaluate whether a particular methodology was appropriate; and
- did not include any mechanism for identifying and reviewing fair-valued securities whose price remained unchanged for weeks, months, or entire quarters.

The SEC said that the fund accountant:

- did not use any reasonably analytical method to arrive at fair value;
- deemed the cost of a security to be its fair value;
- would not change the value unless a sale or price confirmation indicated a more than five percent variance from the previously assigned price;
- routinely accepted prices from a pricing agent without independent verification;
- accepted "opinions" on prices from broker-dealers, rather than actual bids or firm quotes;
- did not identify or explain instances when price confirmations differed materially from the valuation prices used; and
- provided incomplete information about fair valuation and matrix pricing to the funds' directors.

Moreover, the SEC said that the adviser's valuation committee, consisting of fund officers and fund accounting employees, received "insufficient information as to the basis of the fair values assigned to various securities." The valuation committee's report to the board did not state how fair values were determined, and provided no details on how fair valued securities were "randomly confirmed with the third parties," the SEC alleged.

Prior to the commencement of this administrative action, the investment adviser, the portfolio manager, and a fund officer settled SEC charges relating to the same facts. Without admitting or denying the SEC's allegations, the respondents agreed to, among other things, pay disgorgement, interest, and civil penalties.

The standard of care. Throughout the order, the SEC emphasized the standard of care that a board must exercise in fair valuing securities for which market quotations are not readily available.

In particular, in an oft-cited 1970 SEC accounting series release, the SEC said that:

Directors must determine the method of arriving at the fair value of each security.

To the extent necessary, the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board's direction; and

Consistent with this responsibility, the board must also "continuously review the appropriateness of the method used in valuing each issue of security in the company's portfolio."

The allegations. The SEC alleged two basic failures on the part of the directors:

- The valuation method that the fund accountant used was flawed; and
- The directors failed to exercise meaningful oversight of the valuation process.

The SEC alleged that the directors delegated fair valuation to the fund accountant without appropriate oversight. In particular, the SEC said that the directors:

- did not specify a fair valuation methodology pursuant to which the securities were fair valued;

- did not continuously review the appropriateness of the method to be used in valuing each issue of security in the fund's portfolio;
- provided no meaningful substantive guidance on how those determinations should be made;
- did not provide any other guidance, either written or oral, on how to determine fair value beyond what was stated in the valuation procedures;
- did not know and did not inquire what methodology Fund Accounting and Valuation Committee used to fair value particular securities;
- made no meaningful effort to learn how fair values were actually determined; and
- by failing to adopt and implement reasonable procedures, caused the net asset value (NAV) of the funds to be materially misstated for more than two years.

The denial of wrongdoing. The independent directors, through their counsel, emphatically deny the allegations against them. and plan to vigorously contest the charges. The statement on their behalf states that the independent directors were diligent and acted in good faith during the unprecedented market turmoil in 2007, relying on their Chief Compliance Officer and independent auditors for assurances that the valuation process was proper and produced correct fair valuations.

Implications for directors. The SEC rarely brings enforcement actions against independent directors. In those rare instances, the SEC has focused on what they believed were egregious violations or failures to act.

But in 2010, the staff of the Division of Enforcement signaled a change of direction. In testimony before the United States Senate Committee on the Judiciary, Robert Khuzami, the director of the Division of Enforcement, said that newly established risk analytics "are expected to result in examinations and investigations of investment advisers and their boards of directors concerning duties under the Investment Company Act."

Accordingly, no one should be surprised if the SEC brings enforcement proceedings against independent directors, especially in cases involving valuation, compliance oversight and investment advisory contract approvals.

Here, it appears that the SEC is sending a loud wakeup call warning independent directors that it will scrutinize director oversight of fund valuation. In a December 6, 2012 speech, Norm Champ, the director of the Division of Investment Management, acknowledged a need to provide additional guidance on valuation of securities held by registered investment companies. He pointed to source materials on the SEC's website designed to assist funds and their counsel in understanding and applying valuation requirements under the 1940 Act including, among other things, examples of enforcement actions.

The message is clear: The SEC is peering into the boardroom to ensure that independent directors:

- specify fair valuation methodologies pursuant to which securities should be fair valued;
- ensure that valuation procedures provide a meaningful methodology or specific directions on how to make fair value determinations for specific portfolio assets or classes of assets, rather than list factors copied from SEC accounting releases;

- continuously review the appropriateness of the method of determining the value each issue of security in a fund's portfolio;
- make meaningful efforts to learn how fair values are actually being determined; and
- ask the adviser, or the persons delegated to conduct fair valuations, to provide detailed information on the factors they considered in making fair value determinations, and why particular fair values were assigned to portfolio securities.

Directors should recognize that one size does not fit all when it comes to valuation of portfolio securities. Some portfolios may contain "plain vanilla" securities for which market valuations are readily available, while other portfolios may contain more thinly traded issues for which there are fewer reliable market prices available. In any event, directors should review the appropriateness of their funds' valuation procedures, and should consult with the funds' investment adviser, chief compliance officer, auditors, and counsel for guidance on how to appropriately satisfy their responsibilities regarding valuation of portfolio securities. Directors should ensure that the record appropriately documents their valuation efforts.

Contact:

Kelley Howes
(303) 592-2237
khowes@mofo.com

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer*'s A-List for nine straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.