Article.

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SEC Fires Warning Shot: Valuation Responsibility is Important and under Scrutiny

By Jay G. Baris

The Securities and Exchange Commission recently fired a warning shot to remind mutual fund directors that they should take seriously their responsibilities to fair value portfolio securities. While most mutual fund directors are diligent In their oversight of fund valuation, fund directors should take this opportunity to review the adequacy of their valuation policies and procedures.

When it comes to fair valuation of portfolio securities, mutual fund directors must do more than simply delegate responsibility and provide oversight. As the SEC once again has made clear, the Investment Company Act of 1940 places the responsibility to fair value securities squarely on the directors' shoulders.

When a market quotation is available, funds must assign that value to portfolio securities. But, when market quotations are not readily available, funds must assign a fair value "as determined in good faith by the board of directors." This statutory mandate raises the questions: What is "fair value?" What is "good faith?" How do directors establish fair value in good faith?

To further muddy the already opaque waters, many portfolio holdings are no longer plain-vanilla exchange-traded securities, and there is no single acceptable way to fair value any given asset.

To be sure, no one expects a fund's independent directors to file into a trading room each day at the close of business, sit in front of Bloomberg terminals, whip out their HP-12Cs, and calculate the fair value of each portfolio security for which there is no readily available market quotation. But the independent directors can't simply offload this responsibility to a service provider, including the fund accountant or the fund's investment advisor, without active involvement and oversight.

The SEC has acknowledged that in some circumstances "value can be determined fairly in more than one way" and that "no single standard for determining fair value in good faith can be laid down" since fair value depends on the circumstances in each case.[1]

In an effort to provide some clarity, the SEC has given guidance over the years. In a nutshell, the SEC's guidance comes down to this:

- You must consider all relevant factors in determining fair value.
- You may seek "technical assistance" from others to make the actual calculation under their direction,
- But you are responsible for ensuring that the resulting valuations are fair.

[1] SEC Accounting Release 118 (December 23, 1970).

- You must "continuously review" the appropriateness of the fair valuation method.
- Fair value means "the amount which the owner might reasonably expect to receive for them upon their current sale."

In today's boardroom, fund directors establish policies and procedures to fair value securities when no market quotation Is readily available. These procedures frequently delegate many of the technical aspects of a valuation decision to the fund's advisor or fund accountant. But the SEC is clearly of the view that it is not enough to simply delegate this responsibility; you must affirmatively take ownership of the fair valuation process by providing meaningful substantive guidance.

***SEC sues fund directors*.** A case in point: In December 2012, the SEC announced charges against eight former members of the board of directors of several Morgan Keegan closed-end and open-ended funds. The SEC charged that the directors failed to properly fulfill their responsibilities to fair value certain structured products over a seven-month period when the financial markets were beginning to collapse.

***Allegedly faulty valuation procedures*.** While the board, consistent with its responsibilities, had adopted valuation procedures, the board-approved procedures delegated most of the responsibility for determining fair value to the fund accountant. The SEC claimed that these 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.

SEC's claims against the directors. 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.

In addition to the concerns raised about the alleged inadequacy of the valuation procedures, the SEC said that the directors:

- Did not continuously review the appropriateness of the method used to value each of the structured products held in the funds' portfolio;
- Did not provide additional 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 the fund accountant and funds' 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 funds' net asset value to be materially misstated for more than two years.

Not surprisingly, the board has emphatically denied these allegations and provided examples of their diligence and good faith. But even if the directors are ultimately exonerated in full, the damage has been done. The unrecoverable damages to date include legal expenses, time and energy expended to defend the allegations; and harm to reputations.

***Lessons for fund directors*.** The SEC rarely sues fund directors, so this case is exceptional. But, in light of allegations that the SEC did not do enough to avoid the financial crisis and that it failed to detect some major frauds, the SEC seems willing to take a more aggressive stance. Going forward, cases against fund directors, and other fund-related individuals, may become more common as the SEC seeks to reinvigorate its image. Fund directors should expect that the SEC will be peeking through the boardroom door, ready to second-guess the directors when something goes wrong.

Even if you believe that your board has established adequate valuation policies, and you are actively involved in the fair valuation process, this case presents an opportunity to revisit those policies and their procedures for implementing them. You may consider, among other things, whether the procedures they have adopted:

- Specify fair valuation methodologies pursuant to which securities should be fair valued;
- Provide a meaningful methodology or specific direction on how to make fair value determinations for specific portfolio assets or classes of assets, rather than simply listing factors drawn from SEC accounting releases;
- Require the board to "continuously" review the appropriateness of the method of determining the value of each security in a fund's portfolio;
- Require the board to make meaningful efforts to learn how a fund actually determines the fair values of portfolio securities; and
- Obligate fund directors to ask for detailed information about the factors used to make fair value determinations, and why particular values were assigned to portfolio securities.

Records of your board's deliberations regarding fair valuation decisions should reflect the enhanced level of oversight and involvement by the board.

One size does not fit all when it comes to how to fair value portfolio securities. But it is clear that the SEC is looking over your shoulder to ensure that you "continuously" review the appropriateness of a fund's fair value procedures and that the board provides meaningful guidance for how the fund values its portfolio securities.

Contact:

Jay G. Baris
(212) 468-8053
email@mofo.com

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