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A legal update from Dechert's Financial Services Group

Morgan Keegan Settles SEC Fraud Charges Related to Mortgage-Backed Securities Valuations in its Registered Funds

The SEC, state regulators and FINRA on June 22, 2011 announced that Morgan Keegan & Company ("Morgan Keegan") and Morgan Asset Management ("Morgan Asset") agreed to pay $200 million to settle fraud charges related to subprime mortgage-backed securities valuations in their registered funds.[1] Two Morgan Keegan employees—a controller and a portfolio manager—also agreed to pay penalties for their alleged misconduct. The two employees were accused of causing the false valuation of the securities in five funds that Morgan Asset managed from January to July 2007.

The SEC trumpeted the case as demonstrating its continuing efforts to prosecute companies and individuals associated with the subprime mortgage crisis. Robert Khuzami, Director of the SEC's Division of Enforcement, stated that "the falsification of fund values misrepresented critical information exactly when investors needed it most—when the subprime mortgage meltdown was impacting the funds." The case is also important to better understand the SEC's views on appropriately "fair valuing" a fund's portfolio securities. The *Morgan Keegan* case follows several SEC fund valuation cases.

1 *Morgan Asset Management, Inc.; Morgan Keegan & Company, Inc.; James C. Kelsoe, Jr.; and Joseph Thompson Weller, CPA,* Admin. Proc. 3-13847, Exchange Act Rel. No. 64720 (June 22, 2011).

Factual Summary

Morgan Asset, based in Birmingham, Alabama, was the investment adviser to the relevant mutual funds and closed-end funds, and James Kelsoe served as the funds' portfolio manager. Morgan Keegan was the principal underwriter and distributor of shares of the mutual funds.

Morgan Keegan priced each fund's securities and calculated the fund's daily net asset value ("NAV") through its fund accounting department. Joseph Weller, Morgan Keegan's controller, along with other Morgan Keegan personnel, staffed a "valuation committee" that oversaw each fund's accounting processes and evaluated the prices assigned to securities.

Each of the funds held, in varying amounts, securities backed by subprime mortgages, and the market for such securities deteriorated in the first half of 2007. Many of the securities were required to be "fair valued" because market quotations were not readily available.

Valuation Procedures

The funds' board of directors had adopted valuation procedures for pricing the respective funds' portfolio securities and assigned the task of following those procedures to Morgan Keegan. The procedures mandated that such securities should be valued in "good faith" by the valuation committee.

According to the SEC, Morgan Keegan and the valuation committee did not reasonably satisfy their responsibilities under the funds' procedures in several ways. Among other things:

- The valuation committee left pricing decisions to lower level employees in fund accounting who did not have the training or qualifications to make fair value pricing determinations.
- Fund accounting personnel relied on Kelsoe's "price adjustments" to determine the prices assigned to portfolio assets, without obtaining a reasonable basis for or documentation supporting the price adjustments or applying the factors set forth in the procedures.
- Fund accounting personnel gave Kelsoe discretion beyond the parameters of the valuation procedures in validating the prices of portfolio securities by allowing him to determine which dealer price confirmations to use and which to ignore, without obtaining documentation to support his adjustments.
- The valuation committee and fund accounting did not ensure that the fair value prices assigned to many of the portfolio securities were periodically re-evaluated, allowing them to be carried at stale values for months at a time.

Price Adjustments

At various times, Kelsoe had his assistant send "price adjustments" to fund accounting. In many instances, these adjustments were arbitrary and did not reflect fair value. A staff accountant routinely entered the price adjustments upon receiving them into a spreadsheet used to calculate the NAVs of the funds.

Fund accounting did not generally request, and Kelsoe did not generally supply, supporting documentation for his price adjustments. Fund accounting and the funds did not record the securities for which Kelsoe had assigned values.

Third-Party Confirmations

As part of the valuation procedures, fund accounting sometimes requested third-party broker-dealer price confirmations as a means to validate the values it had assigned to the funds' fair valued securities. Fund accounting generally allowed Kelsoe to determine whether broker-dealer price confirmations were used or ignored.

Fund Accounting

The head of fund accounting reported to Weller. According to the SEC, Weller knew, or was reckless in not knowing, of the deficiencies in the implementation of the valuation procedures, and failed to remedy them or otherwise make sure fair-valued securities were accurately priced. During the relevant period, Weller was aware that:

- The valuation committee did not adequately supervise fund accounting's application of the valuation factors.
- Kelsoe was supplying fair value price adjustments for specific securities to fund accounting, but the members of the valuation committee did not generally know which securities Kelsoe supplied fair values for, or what those fair values were, and did not generally receive supporting documentation for those values.
- The only other pricing test regularly applied by the valuation committee was a "look back" test, which compared the sales price of any security, sold by a fund, to the valuation of that security used in the NAV calculation. The test only covered securities after they were sold; thus, at any given time, the valuation committee never knew how many securities' prices could ultimately be validated.

Weller nevertheless signed the funds' annual and semi-annual financial reports with Sarbanes-Oxley certifications.

Violations

The SEC concluded that the parties either violated, caused, or aided and abetted violations of the following federal securities laws:

(1) *Advisers Act Section 206(1) and (2)*. Morgan Asset failed to disclose to the funds' boards that it was not complying with the valuation procedures.

(2) *Advisers Act Section 206(4)*. Morgan Asset did not adopt appropriate compliance policies and procedures.

(3) *Investment Company Act Section 34(b)*. The funds' SEC-filed documents misrepresented the funds' performance.

(4) *Investment Company Act Rule 22c-1*. The funds' shares were not accurately priced.

(5) *Investment Company Act Rule 38a-1*. The funds did not adopt appropriate compliance policies and procedures.

Sanctions

Morgan Keegan and Morgan Asset agreed to the following sanctions:

- Censure.
- Cease and desist from committing future related violations.
- Barred for three years from being involved in, or responsible for, the fair value of any fund portfolio security.
- An undertaking that if after three years, but within six years from the date of the order, they become involved in such activities, they must hire an independent consultant to review their procedures.
- Provide a certification to the SEC that they have complied with the undertaking no later than 60 days after compliance.
- Fully cooperate with the SEC in any further investigations regarding trading in or valuing a fund's portfolio securities.
- Jointly and severally pay $200 million in disgorgement and civil penalties.

Kelsoe agreed to the following sanctions:

- Cease and desist from committing future related violations.
- Pay $250,000 in civil penalties.
- Permanently barred from association with any SEC-regulated entities, including any broker-dealer and investment adviser.

Weller agreed to the following sanctions:

- Cease and desist from committing future related violations.
- Barred for two years from appearing or practicing before the SEC as an accountant.
- Pay $50,000 in civil penalties.

Related Cases

The *Morgan Keegan* case follows several SEC fund portfolio valuation cases, which include:

- *Evergreen Investment Management Company*. In June 2009, the SEC settled a case against Boston-based Evergreen Investment Management Company and an affiliate for overstating the value of a mutual fund that invested primarily in mortgage-backed securities, and then only selectively telling shareholders about the fund's valuation problems. Evergreen paid more than $40 million in disgorgement and civil penalties.[2]
- *Heartland Advisors Inc*. In January 2008, the SEC settled a case against Heartland Advisors for mispricing certain bonds owned by its funds and its failure to effectively communicate to the funds' board of directors, and to investors, important facts concerning Heartland's efforts to evaluate bond issuers. Also, information was presented to the directors that should have alerted them that the bonds were becoming increasingly illiquid and may have been mispriced. Heartland Advisors paid a civil penalty of $3.5 million, and the directors settled with a cease and desist.[3]
- *Piper Capital Management, Inc*. In August 2003, the SEC found in a litigated proceeding that investment adviser Piper Capital and an associated person, among other things, fraudulently priced a fund's NAV, placed false information on the fund's daily reports, and willfully aided, abetted and caused that fund to sell and redeem shares at prices that were not based on the fund's current NAV, and failed to maintain appropriate books and records. Piper Capital was ordered to pay a civil penalty of $2 million.[4]

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2 *Evergreen Investment Management Company, LLC and Evergreen Investment Securities, Inc*, Admin. Proc. 3-13507, Exchange Act Rel. No. 60059 (June 8, 2009).

3 *Heartland Advisors, Inc., William J. Nasgovitz, Paul T. Beste, Thomas J. Conlin, Greg D. Winston, Kevin D. Clark, Kenneth J. Della, and Hugh F. Denison*, Admin. Proc. 3-12936, Exchange Act Rel. No. 8884 (Jan. 25, 2008).

4 *Piper Capital Management, Inc., Marijo A. Goldstein, Robert H. Nelson, Amy K. Johnson, and Molly J. Destro*, Admin. Proc. 3-9657, Securities Act Rel. No. 8276 (Aug. 26, 2003).

Conclusion

From the SEC cases regarding fund portfolio securities valuations, several lessons continue to ring true. A fund group should adopt sound procedures for pricing portfolio securities, including "fair valuation" procedures. The procedures should be accurately described in disclosure documents and fund/adviser personnel should follow the stated procedures. As part of the procedures, there should be checks and balances so that one person does not have the ability to circumvent the system. Moreover, the fund's board of directors must be apprised of any material compliance problems and take appropriate corrective actions.

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