Client Alert

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SEC Slaps Fund Directors for Violating Fair Value Responsibilities

By Jay G. Baris

On June 13, 2013, without admitting or denying the allegations, eight former directors of five mutual funds agreed to settle SEC charges that they failed to satisfy their fair valuation responsibilities under federal securities laws. The SEC did not require the directors to pay a fine or monetary penalties, but required them to "cease and desist" from future violations.

The funds at issue were heavily invested in securities backed by subprime mortgages. As a result of the alleged violations, the SEC said that the funds overstated the value of their securities as the housing market was on the brink of a financial crisis in 2007. The funds' investment adviser and others previously agreed to pay $200 million to settle charges on related conduct.

Directors' responsibilities to fair value securities. In general, when market prices of portfolio securities are not readily available, fund directors must determine the fair value of those securities in good faith. In 1970, the SEC said that in doing so, the directors must:

> determine the method of arriving at the fair value of each such security. To the extent considered 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. The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security in the company's portfolio.

Alleged violations. The SEC alleged that the directors:

- did not specify a fair valuation methodology pursuant to which the funds should fair value their portfolio securities;
- did not continuously review how each security in the portfolios was being fair valued;
- delegated their responsibility to determine fair value to a Valuation Committee of the investment adviser, but did not "provide any meaningful substantive guidance on how those determinations should be made"; and
- did not learn how fair values were actually being determined.
- The SEC said that these alleged failures were significant because the fair valued securities made up the majority of the funds' portfolio securities during the period in question.

The SEC said that the funds' valuation procedures provided general guidance, listing "various and specific factors" that the adviser's valuation committee should consider when making fair value determinations. The SEC noted that the procedures "copied nearly verbatim" a list of factors to be considered from an SEC release discussing fair valuation, but that the procedures "provided no meaningful methodology or other specific direction on *how* to make fair value

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determinations for specific portfolio assets or classes of assets." The SEC emphasized that the board provided no other guidance on how to fair value the securities beyond what was contained in the procedures.

The SEC described the actual procedures that the funds' accountants employed, alleging that the accountants "did not use any reasonable analytical method to arrive at fair value." Among other things, the SEC noted that the accountants would only change a fair value if a sale or price confirmation indicated a more than five percent variance from the previously assigned fair value. Accordingly, the SEC found that the funds' net asset values (NAVs) were inaccurate for a period of weeks.

The SEC also found that the reports provided to the directors at their regular meetings "did not provide sufficient information for the Directors to understand what methodology was being used" to fair value securities.

Although the directors received confirmations that the fair value prices were randomly confirmed by third parties, and that no material exceptions were noted, the SEC emphasized that the reports did not describe how the securities were fair valued, and that the directors "never established any guidelines regarding the use of price confirmations."

The SEC noted that "outside counsel advised the Directors" in connection with the adoption of the valuation procedures, and that the funds' independent auditors provided unqualified opinions on the funds' financial statements and advised the directors that the fair valuation procedures were appropriate and reasonable. The auditors, however, were not retained to advise the directors on the effectiveness of internal controls.

The order summarized prior guidance on the responsibilities of a fund's board to adopt and implement compliance procedures that are "reasonably designed to prevent violations of the securities laws, including policies and procedures concerning a fund's determination of the fair value of portfolio securities."

Quoting from a 1970 release, the SEC cautioned that "while a board may enlist the assistance of individuals who are not board members, it remains the board's duty to establish the fair value methodology to be used and to continuously review *both* the appropriateness of the methods used in valuing each issue of security and the valuation findings resulting from such methods."

Here, the SEC said that by failing to approve the actual methodologies used to fair value securities, the directors violated their responsibilities under Rule 38a-1 with regard to the adoption and implementation of procedures reasonably designed to prevent violations of federal securities laws.

Commentary. Some observers have characterized the SEC's action as regulation by enforcement, saying that the settlement effectively goes beyond existing published regulatory guidance and is contrary, at least in some ways, to widely accepted practices. The other side of the argument is that the SEC's position has not changed; rather it is now enforcing principles that arguably it should have been more vigorously pursuing in the past.

The settlement may also call into question the ability of fund directors to rely on their service providers, including their counsel and their auditors. The references to counsel and auditors within the order could be read as an implication that others had some role in the alleged failures by the fund directors.

Finally, the settlement will serve as a catalyst for fund boards and advisers to debate the extent to which they must now attempt to include "recipes" for fair valuation of every type of portfolio security in every circumstance in their fair valuation procedures.

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In any event, it is clear that the SEC is sending a wake-up call to fund directors, their counsel and their auditors in the area of fair value pricing. We await further guidance from the SEC on this matter.

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