SEC Brings Enforcement Action Against Mutual Fund Directors For Alleged Failures in Oversight of Valuation Committee

On December 10, 2012, the SEC filed an order instituting enforcement proceedings (the "OIP") against both the interested and the independent directors of five registered investment companies advised by Morgan Asset Management, Inc. (the "Adviser"), alleging that the directors failed to properly carry out their duties during several months in 2007 with respect to overseeing the determination of the "fair value" of certain structured product securities owned by four closed-end funds and three series of an open-end investment company (the "Funds"). A copy of the OIP can be found by clicking here.

The OIP represents a rare instance in which the SEC has instituted proceedings against fund directors and comes nearly 18 months after the Adviser settled a separate SEC enforcement proceeding on the same underlying facts. The OIP alleges that the directors delegated their asset-pricing responsibilities to the Adviser without giving adequate guidance on how the valuations should be made or ascertaining how the values were determined. Although it represents only the beginning of a formal fact-finding and litigation process, the OIP raises practical questions regarding how boards of directors fulfill their responsibilities with respect to valuation.

Facts and Allegations in the OIP

Valuation Procedures of the Funds

During the period from January 2007 to August 2007, a large percentage of the securities owned by the Funds consisted of subordinated tranches of various structured products that included collateralized mortgage obligations and other types of asset-backed securities. Market quotations were not readily available for many of these securities and at times up to 60% of the portfolios of some Funds were required to be "fair valued" by the Funds' board of directors (the "Board") in accordance with Section 2(a)(41)(B) of the Investment Company Act and the Funds' policies and procedures. The Board delegated responsibility for making fair value determinations to the Adviser, instructing that such determinations be made "in accordance with the Funds' Valuation Procedures." The Funds' Valuation Procedures stated that fair value determinations were to be made by the Adviser's Valuation Committee and listed several factors for making such determinations. According to the SEC, "[o]ther than listing these factors, which were copied nearly verbatim from [Accounting Series Rule] 118, the Valuation Procedures provided no meaningful methodology or other specific direction on *how* to make fair value determinations for specific portfolio assets or classes of assets." The Valuation Procedures also required that the Valuation Committee provide to the Board for their review "[q]uarterly reports listing all securities held by the Fund that were fair valued during the quarter under review, along with explanatory notes for the fair values assigned to the securities."

Alleged Fair Valuation Practices

The OIP alleges that the process employed in making the daily fair valuation determinations for the Funds, which in practice was actually performed by the Fund Accounting group ("Fund Accounting") at the Funds' distributor, Morgan Keegan & Company, Inc. ("Morgan Keegan"), was deficient in many respects. Indeed as noted below, Morgan Keegan had previously settled a $100 million SEC enforcement proceeding involving valuation issues with respect to the Funds during the same 2007 period.[1] According to the OIP, Fund Accounting did not use any reasonable analytical method to arrive at fair value, and securities were typically

[1] In addition to the settlement of the SEC enforcement proceedings, Morgan Keegan also settled related enforcement proceedings brought by FINRA and state regulators from Alabama, Kentucky, Mississippi, South Carolina and Tennessee, which required that Morgan Keegan pay an additional $100 million for restitution to its customers.

valued at cost upon acquisition and thereafter such values were not adjusted unless a sale or a price confirmation indicated a more than 5% variance. Price confirmations, in the form of opinions from broker-dealers (rather than bids or firm quotes), were randomly requested for a small percentage of the securities required to be fair valued and took several weeks to obtain. Nonetheless, Fund Accounting regularly relied on such confirmations in making daily fair value decisions. In addition, if a price confirmation indicated a more than 5% variance from the assigned value, Fund Accounting "effectively allowed" the Funds' portfolio manager (James Kelsoe) to select the fair value, despite the fact that Kelsoe's values often diverged from the price confirmations that were obtained.

The OIP alleges that the Board did not know and did not inquire as to the manner in which the Valuation Committee and Fund Accounting were making fair value determinations of particular types of securities and did not receive information that would allow the directors to understand the methodology that was being used to fair value securities. The SEC notes that although the Board met more frequently and inquired about liquidity and valuation after being contacted by the SEC staff regarding valuation issues in July of 2007, the Board never asked specific questions about valuation methodology and testing.

Alleged Violations

The OIP alleges that the failure of the Funds to properly fair value their securities caused the Funds' NAVs to be materially misstated, causing errors in the prices at which the open-end funds sold or redeemed shares and material misstatement of NAVs in at least one registration statement. The SEC attributes responsibility for these errors directly to all eight members of the Board, but specifically mentions that all six independent directors on the Board sat on the Funds' Audit Committee and were also each designated as an Audit Committee Financial Expert. The SEC claims that the Board caused the Funds to fail to adopt and implement reasonable valuation procedures and that the Board's conduct resulted in the following violations:

- Rule 22c-1 under the Investment Company Act, which makes it unlawful for open-end funds to sell or redeem securities except at a price equal to their current NAV;
- Rule 30a-3(a) under the Investment Company Act, which requires registered investment companies to maintain internal control over financial reporting;
- Rule 38a-1 under the Investment Company Act, which requires registered investment companies to adopt written policies and procedures reasonably designed to prevent violations of securities laws; and
- Willfully causing a false or misleading statement or omission to be made in a registration statement.

Backdrop of Past Proceedings Against the Adviser and Morgan Keegan

The current enforcement action against the Board was preceded by a separate proceeding (the "Morgan Keegan Proceeding") based on the same underlying facts that was instituted by the SEC on April 7, 2010, against the Adviser, Morgan Keegan, James Kelsoe (the portfolio manger of the Funds), and Joseph Weller, the Funds' treasurer (to whom Fund Accounting reported). Shortly thereafter, the SEC launched a separate investigation against the Board. On June 22, 2011, the respondents in the Morgan Keegan Proceeding entered into a settlement with the SEC (the "2011 Settlement") that included payment by the Adviser and Morgan Keegan of $25,000,000 in disgorgement and pre-judgment interest and $75,000,000 in civil penalties. Although the facts recited in the 2011 Settlement were generally similar to the facts alleged in the OIP, much more attention was paid in the 2011 Settlement to how the conduct of Kelsoe and Weller resulted in the incorrect valuations of portfolio securities. In particular, the 2011 Settlement describes at length Kelsoe's role in

providing unsubstantiated valuations of securities which were accepted by Fund Accounting and the manner in which Kelsoe improperly influenced the process of obtaining price confirmations from third-party brokers.

The litigation leading up to the 2011 Settlement was contentious. Morgan Keegan asserted that the SEC started its new investigation of the Board "simply as a ploy" to get around the fact that it had failed to obtain sworn testimony of the directors during the applicable time period of the investigation leading up to commencement of the Morgan Keegan Proceeding. The administrative law judge who ruled on this dispute concluded that the investigation of the Board was a continuation of the Morgan Keegan Proceeding and blocked the SEC from taking the testimony of the directors until after the hearing in the Morgan Keegan Proceeding was concluded. By commencing its action with the OIP in late 2012, long after the Morgan Keegan Proceeding was settled, the SEC is contradicting the assertion that its only enforcement interest in the Board was to gather evidence against Morgan Keegan.

On the same date as the OIP, the lawyers for the independent directors named in the OIP issued a statement indicating that their clients "emphatically deny" the SEC allegations and intend to vigorously contest this case. The statement also asserts that in 2007 the directors were advised by independent auditors from a major accounting firm that the Funds' "valuation procedures were reasonable and appropriate, and that the process was working properly and producing correct fair valuations." The lawyers for the independent directors go on to say that the directors received similar assurances from the Funds' Chief Compliance Officer.

Implications for Fund Directors

Although not unprecedented, it is unusual for the SEC to bring an enforcement action against directors of registered investment companies. In past actions implicating directors, the SEC tended to allege aggravating factors against directors such as lack of good faith (under applicable accounting standards) and active participation of the directors in valuing a specific security,[2] or repeated failures to follow up on requests for valuation information and uncritical acceptance of flawed explanations of serious liquidity problems offered by the adviser.[3] It is not clear to what degree the SEC's present action against the Board represents an isolated instance that can be distinguished due to the particular facts or history of the case, and to what degree the SEC is signaling to the industry that it is now seeking to hold directors liable in the event they fail to meet a standard of oversight that has not been previously articulated. In any event, valuation issues continue to be a high priority concern of the SEC and its staff, having resulted in several recent enforcement actions[4] and being listed consistently near the top of the list on examination priorities[5] over the past several years. Norman Champ, the Director of the Division of Investment Management also recently stated that valuation will be one

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[2] Parnassus Invs., Exchange Act Release No. 40534, 68 SEC Docket 586 (Oct. 8, 1998).
[3] Hammes, Securities Act Release No. 8346, Investment Company Act Release No. 26290, 81 SEC Docket 2467-7 (Dec. 11, 2003).
[4] Such recent cases include Morgan Asset Mgmt., Inc., Exchange Act Release No. 64720, Investment Company Act Release No. 29704, Fed. Sec. L. Rep. (CCH) ¶ 89,474 (June 22, 2011); Premo, Investment Company Act Release No. 29919, 2012 SEC LEXIS 140 (Jan. 17, 2012); UBS Global Asset Mgmt. (Americas), Inc., Investment Company Act Release No. 29920, Fed. Sec. L. Rep. (CCH) ¶ 89,702 (Jan. 17. 2012); SEC v. ICP Asset Mgmt, LLC, Litigation Release No. 21563, 2010 SEC LEXIS 2020 (June 22, 2010), Litigation Release No. 21958, 2011 SEC LEXIS 1607 (May 5, 2011), Litigation Release No. 22024, 2011 SEC LEXIS 2269 (July 1, 2011), Litigation Release No. 22477, 2012 SEC LEXIS 2848 (Sept. 10, 2012); KCAP Fin., Inc., Exchange Act Release No. 68307, 2012 SEC LEXIS 3662 (Nov. 28, 2012).
[5] Andrew Bowden, Deputy Director, Office of Compliance Inspections and Examinations, SEC, Letter to Industry Regarding Presence Exams, 3 (Oct. 9, 2012), *available* here; Ropes & Gray Alert: Senior SEC Officials Discuss Asset Management Examination and Enforcement Initiatives and Priorities for 2012 (Feb. 7, 2012); Ropes & Gray Investment Management Update: Oct.-Nov. 2012: SEC Announces Presence Exam Initiative (Nov. 26, 2012). For a discussion on how the SEC has been focusing on valuation issues generally, see SEC, *CCOutreach* Program Interactive Broadcast Seminar on Valuation (Oct. 7, 2010), *available* here;

of the Division's top priorities in the coming months, acknowledging that "there is a need to provide additional guidance on valuation of securities held by registered investment companies."[6]

Based on the language of the OIP, several preliminary lessons can be taken as to the SEC enforcement staff's current views of the directors' role in overseeing fair value processes and procedures. The SEC specifically did not fault the Board for delegating much of the fair value process to the Adviser's valuation committee. Nor does the SEC allege any bad faith or active participation by the directors in the acts of the Adviser. Rather the SEC alleges that the directors were negligent in carrying out their statutory valuation duties in the following ways:

- Failing to provide the valuation committee with meaningful substantive guidance on how fair valuation decisions should be made;
- Making no meaningful effort to learn how fair values were being determined;
- Failing to receive sufficient information about the factors used in making fair value determinations; and
- Failing to obtain sufficient information explaining why particular fair values were assigned to specific portfolio securities.

The OIP is but the first salvo in the formal proceedings brought against the directors and does not represent established precedent. Nevertheless, the types of procedural and supervisory expectations implicit in these allegations raise significant concerns over how fund directors can practically satisfy the SEC or its staff when overseeing complex funds that utilize a wide range of investment instruments amidst challenging market conditions. While further context may be forthcoming from the SEC and its staff (either through the current case or through much-anticipated guidance on valuation), in the interim boards of registered funds may wish to consider taking stock of their fair valuation procedures. In particular, directors may want to seek input from counsel and from the advisers to their Funds with regard to the adequacy of their current oversight and compliance structures, the types of information they receive, the scope of their reliance on third-party experts, and the role of portfolio managers and other adviser personnel in the valuation process.

[6] Norm Champ, Director, Div. of Inv. Mgmt., SEC, Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services (Dec. 6, 2012), *available* here.

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