SEC Settles with Fund Directors for Failure to Satisfy Valuation Responsibilities

On June 13, 2013, the SEC filed an order settling administrative proceedings (the "Order") against eight former directors (the "Directors") of five Regions Morgan Keegan open- and closed-end funds (the "Funds") that had been heavily invested in securities backed by subprime mortgages in the lead-up to the 2008 financial crisis. In the Order, the SEC found that the Directors caused the Funds to violate Rule 38a-1 under the Investment Company Act of 1940 (the "1940 Act"), which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. A copy of the Order can be found by clicking here.

Although it is unusual for the SEC to bring enforcement actions against directors of funds, George S. Canellos, Co-Director of the SEC's Division of Enforcement, stated that the SEC settlement "sends a clear warning of our commitment to enforce the duty of mutual fund directors and trustees to closely oversee the process of valuing securities held by their funds."[1] Notably, this is the second time in the past few months that the SEC has directly sanctioned fund directors for alleged failures of oversight, including causing a fund's violations of Rule 38a-1.[2]

SEC Findings and Comparison to the Order Instituting Enforcement Proceedings

The Order found, among other things, that:

- The Directors delegated their fair valuation responsibility to a valuation committee of the Funds' adviser without providing adequate substantive guidance on how fair valuation determinations should be made;
- The Directors made no meaningful effort to learn how fair values were being determined;
- The Directors received limited information about the factors supporting the Funds' fair value determinations and almost no information explaining why particular fair values were assigned to specific portfolio securities; and
- The investment adviser's valuation committee, to which the Directors delegated fair valuation responsibilities, did not utilize reasonable procedures and often allowed the portfolio manager to arbitrarily set values, resulting in an overstatement of the value of the Funds' shares.

The Order's findings are significantly more limited than the SEC's allegations in the original order instituting proceedings (the "OIP") against the Directors. The OIP[3] alleged violations in various areas that did not result in findings in the Order, including:

[1] Press Release, SEC, Former Mutual Fund Directors Agree to Settle Claims That They Failed to Properly Oversee Asset Valuation (SEC Press Release 2013-111) (June 13, 2013).
[2] On May 2, 2013, as noted in a previous Ropes & Gray Alert, the SEC settled an action against trustees of Northern Lights Fund Trust and Northern Lights Variable Trust for causing false or misleading disclosures to be issued about the factors they considered when approving investment advisory contracts, as well as causing fund violations of Rule 38a-1 in approving compliance programs of service providers based on inadequate information.
[3] More information about the OIP and related proceedings against the adviser and Morgan Keegan is available in a previous Ropes & Gray Alert.

- Rule 22c-1 under the 1940 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 1940 Act, which requires funds to maintain internal control over financial reporting; and
- That the Directors willfully caused a false and misleading registration statement to be filed with the SEC.

The Directors did not admit to causing fund violations of Rule 38a-1, the sole remaining finding in the Order, nor were they subject to any monetary fines or other penalties. The Directors were ordered to cease and desist from committing or causing any violations and any future violations of the rule (a *pro forma* measure, given that the Directors no longer oversee the Funds).

Implications for Fund Directors

We believe it important to keep in mind that the Order represents a negotiated settlement to an SEC enforcement action based on particular facts and circumstances and does not constitute formal guidance regarding a board's fair valuation responsibilities from the SEC or its staff. While boards may benefit from reviewing their practices in light of the Order, the SEC staff has indicated that more comprehensive valuation guidance may be forthcoming in the relatively near term, which may require additional board review of valuation practices.[4]

The Order alleges that, in this case, the Directors' conduct at issue did not comport with SEC valuation guidance from 1970 which states 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 security and the valuation findings resulting from such methods.[5] There historically has been, and continues to be, uncertainty as to the scope of delegation of valuation that is permitted under the SEC's 1970 (and subsequent) guidance. The Order provides an example of circumstances that the SEC believes constitute impermissible delegation.

It is notable that the Order found that the Board's reliance on experts and advisors was not sufficient in and of itself to avoid violations of Rule 38a-1. The adopting release for Rule 38a-1 states that boards should "consult with fund counsel (and independent directors with their counsel), compliance specialists and other experts familiar with compliance practices successfully employed by similar funds or service providers."[6] The Order alleged that although (i) the Directors were advised by outside counsel in connection with the adoption of written valuation procedures, and (ii) independent auditors audited the financial statements of the Funds as of the Funds' fiscal year-end dates, and during such audits provided "unqualified opinions and advised the Directors that the Valuation Procedures were appropriate and reasonable," the Directors did not obtain sufficient information about the valuation methodologies to satisfy their obligations. As with the

[4] Norm Champ, the Director of the SEC's Division of Investment Management, announced at the end of 2012 that valuation would be one 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." Norm Champ, Dir., 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).

[5] Accounting Series Release No. 118: Accounting for Investment Securities by Registered Investment Companies, Inv. Co. Act Rel. No. IC-6295 (1970) ("ASR 118").

[6] Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. IC-26299, SEC Tracker Archive (CCH) (2003) ("Rule 38a-1 Adopting Release").

imprecise line between appropriate oversight and impermissible delegation, there has been uncertainty as to the extent to which directors may reasonably rely on experts and advisers in connection with their oversight of compliance matters (including reports by chief compliance officers). This settlement provides some indication of when, in the SEC's view, reliance on experts is not sufficient.

Because the Order relates to specific facts and circumstances, boards should not necessarily assume that the uncertainties described above can be addressed simply by avoiding the somewhat egregious practices alleged in the Order. Pending the release of further guidance, specific areas highlighted by the Order that funds and their boards may wish to consider include:

- Revisiting reporting with respect to stale prices;
- Better understanding the role of portfolio managers and broker quotes in pricing securities;
- Consideration of back-tested results of past fair valuations to test valuation policies; and
- Consideration of circumstances, if any, when a board may wish to ratify valuation decisions made by the investment adviser.

More broadly, one key lesson is that fund boards should continue to consider oversight of valuation among their core responsibilities, and bear in mind that valuation is not a "set it and forget it" function. Funds and their boards should also expect continued SEC scrutiny in the area of fair valuation and oversight, and should do their best to identify issues proactively.

If you would like to learn more about the developments discussed in this Alert, please contact the Ropes & Gray attorney with whom you regularly work or any member of the Ropes & Gray Investment Management group listed below.

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