CLIENT UPDATE

FUND DIRECTORS CHARGED IN RECENT SEC ENFORCEMENT CASE TARGETING VALUATION

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For the past year, top officials of the Securities and Exchange Commission (SEC) have repeatedly identified the valuation of illiquid assets held by registered funds and private equity and hedge funds as one of the regulatory agency's top five areas of enforcement focus. And, true to its word, the SEC has been actively pursuing such investigations. Earlier this week, the SEC charged eight former members of the board of directors of Morgan Keegan & Co. mutual funds for abdicating their responsibility to oversee the valuation processes and procedures for securities held by the funds.[1] As the SEC noted in its press release, the administrative action against the fund directors, which comes on the heels of two other recent valuation actions, offers further evidence that "[t]he SEC Enforcement Division's Asset Management Unit continues to prioritize asset valuation investigations."[2] Importantly for fund directors and managers, these actions also signal the SEC's willingness to charge senior fund officials for failing to ensure the fair valuation of hard-to-value securities.

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1 *In the Matter of J. Kenneth Alderman, CPA et al.*, Administrative Proceeding, File No. 3-15127 (Dec. 10, 2012).

2 SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation, SEC Press Release No. 2012-259 (Dec. 10, 2012).

BACKGROUND

In its order instituting proceedings against the fund directors, the SEC alleges that between January 2007 and August 2007, the funds invested a majority of their combined $3.85 billion net asset value (NAV) in below-investment grade debt securities backed by subprime mortgages, for which no readily available market quotations existed.[3] Under the Investment Company Act, those securities were required to be valued at fair value as determined in good faith by the directors. The SEC alleges that the directors delegated their "statutory fair valuation obligations" to the Valuation Committee at Morgan Asset, the investment adviser to the funds, and failed to provide any "meaningful substantive guidance" to the committee on how the valuation determinations should be made. Specifically, the SEC asserts that the directors did not provide detailed guidelines for the Valuation Committee to consider when valuing portfolio securities or specify what methodology should be employed for valuing each type of security. Moreover, the directors, who were independent trustees who also served on the Audit Committees of the funds, allegedly made no effort to learn how fair values were being determined, and reports provided to the Board did not give sufficient information for the directors to understand the methodology underlying the valuation of the securities. The SEC alleges that, as a result, employees tasked with valuing the securities did not utilize reasonable procedures when making valuation determinations. Instead, the employees set fair value at a security's purchase price or allowed portfolio managers to "arbitrarily set values" in a way that postponed the degree of decline in the NAVs of the Funds. The SEC particularly highlights the failure of the Board to follow its own valuation procedures, which required that directors be given explanatory notes for the fair values assigned to securities. According to the SEC, no meaningful notes were ever provided to the directors, and the directors never followed up to request notes or any other specific information, resulting in an arbitrary process that led to materially misstated NAVs.[4]

The SEC's targeting of fund directors is a stark warning to fund directors and all fund personnel charged with management or oversight duties that they need to take their responsibilities for overseeing fund management seriously, even with respect to the complex and technical area of asset valuation. Fund directors and managers should

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3 In 2011, the SEC settled claims against Morgan Keegan fund managers, who were alleged to have defrauded investors by overvaluing risky subprime mortgage securities. As part of the settlement, the firm agreed to pay approximately $220 million. *See In the Matter of Morgan Asset Management, Inc., et al.*, Administrative Proceeding, File No. 3-13847 (June 22, 2011).

4 It should be noted that the case is contested, and it remains to be seen to what extent, if any, the advisers to the Board provided advice to the directors on valuation issues.

review their policies and procedures surrounding asset valuation to ensure the robustness and efficacy of the firm's valuation practices. Moreover, they should be alert to their oversight responsibilities, taking note that delegation without oversight can result in a claim that the responsibilities have been abdicated.

OTHER RECENT CASES DEMONSTRATE THE SEC'S CONTINUED PRIORITIZATION OF VALUATION ISSUES

The *In re Alderman* case is the third valuation case brought by the SEC in the past two months. In October, in a case that drew significant media attention, the SEC filed a civil injunctive action against a hedge fund advisory firm and two of its executives for scheming to overvalue assets under management in order to exaggerate reported returns, hide losses, and collect increased fees. In the case, captioned *SEC v. Yorkville Advisors, LLC*,[5] the SEC alleges that Yorkville executives ignored obvious negative information about investments and simply used the face value of many of the convertibles without attempting to determine the fair value through any of the methodologies represented to investors or to Yorkville auditors. According to the allegations, this practice violated Yorkville's valuation policies, which stated that if market quotations were unavailable, unreliable, or not reflective of the security's market value, the Valuation Committee must revalue the holdings based on a number of stated factors.

In November, the SEC filed and settled administratively *In the Matter of KCAP Financial, Inc., et al.*,[6] in which the SEC alleged that KCAP failed to account for certain market-based activity – such as discount, prepayment, and default rates – when determining the fair values of its debt securities and two of its largest collateralized loan obligation funds (CLOs). According to the SEC, KCAP's utilization of a methodology based on enterprise value rather than exit price both failed to conform with FAS 157 and violated KCAP's own valuation policies. Ultimately, the valuation procedures resulted in a material overvaluation of NAV and the need to restate KCAP's financials for all four quarters of fiscal year 2008 and for the first two quarters of 2009.

IMPLICATIONS FOR ASSET MANAGERS AND NEXT STEPS

The trio of valuation cases, which come in the midst of an expanded examination regime and the Aberrational Performance Inquiry, an initiative by the Asset Management Unit that uses proprietary risk analytics to identify investment advisers with suspicious returns,

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5 Civil Action No. 12-CV-7728 (S.D.N.Y., Oct. 17, 2012).

6 Administrative Proceeding, File No. 3-15109 (Nov. 28, 2012).

reinforce that asset managers must ensure that they and their employees pay strict attention to valuation practices. In particular, the cases suggest that the SEC continues to scrutinize valuations in which illiquid securities comprise a significant portion of a funds' total portfolio or in which a firms' valuation practices diverge from its stated policies and procedures.

Additional guidance may be on the way to assist firms in making valuation determinations. Norm Champ, SEC Director of the Division of Investment Management,[7] acknowledged in remarks last week that much has changed in this area and identified as a potential future regulatory initiative the need to provide updated guidance to registered investment advisers on the valuation requirements under the Investment Company Act. In the meantime, firms should anticipate increased SEC scrutiny. During an examination or in preparation for an upcoming examination, firms should be prepared to speak to their valuation policies and procedures. Methods for valuing illiquid securities should be clearly documented and should consist of reasonable analytical procedures. Directors and senior management should ensure that the stated policies and procedures are being followed. In addition, asset managers should test internal controls and ensure they are properly designed to value illiquid assets and take into account relevant market inputs.

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Please do not hesitate to contact us if you have any questions.

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7 Norm Champ, Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services (Dec. 6, 2012), *available at* http://www.sec.gov/news/speech/2012/spch120612nc.htm