

Client Alert

Current Issues Relevant to Our Clients

June 27, 2013

Valuation Procedures at Center of Morgan Keegan Settlement

On June 13, 2013, eight former members of the board of directors (the “Board”) overseeing five registered investment companies (the “Funds”) advised by Morgan Keegan Asset Management, Inc. (“Morgan Keegan”) settled with the Securities and Exchange Commission (the “SEC”), accepting a cease-and-desist order to cease committing certain violations of the federal securities laws (the “Order”) stemming from inadequacies in the Funds’ fair valuation procedures. Significantly, the SEC determined that the Board failed to establish adequate guidance and made no meaningful attempt to ensure that a reasonable methodology was employed to determine fair value of certain portfolio securities. The Order follows an earlier settlement by Morgan Keegan in 2011 for \$200 million. A copy of the Order is available [here](#).

In December 2012, the SEC instituted cease and desist proceedings against the Board alleging, among other claims, that the Board: (i) failed to establish proper valuation procedures for the Funds’ assets (the “*Valuation Procedures*”); (ii) delegated valuation responsibilities to Morgan Keegan’s valuation committee (the “*Valuation Committee*”) without providing substantive guidance and sufficient oversight; and (iii) made no meaningful effort to learn how fair values were being established. As a result of the insufficient guidance in the Valuation Procedures and oversight of the Valuation Committee, the SEC alleged that the Board failed to uncover the fact that the Valuation Committee was not using any reasonable analytical methodology to arrive at fair value for the Funds’ assets, and the Board did not understand the basis or methodology used for the fair value determinations given the inadequate information provided to it. The Funds’ valuation practices caused the Funds’ net asset values to be inaccurate at least from March 2007 through August 2007, and therefore the prices at which Fund shares were purchased and redeemed were also inaccurate.

Pursuant to Rule 38a-1 of the 1940 Act (“*Rule 38a-1*”), funds are required to implement policies and procedures designed to prevent the violation of securities laws. A fund’s board is responsible for ensuring the fund fulfills this obligation, including, in particular, the policies and procedures concerning determinations of fair value. It is 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.” As discussed in the Order, the SEC determined that the Board adopted insufficient policies and procedures that did not provide a clear and specific valuation methodology. Although the Valuation Procedures

generally listed criteria for establishing valuation, the SEC criticized the Board for merely copying factors from the SEC-issued Accounting Series Release 118 and not taking additional steps to implement a “meaningful methodology or other specific direction on *how* to make fair value determinations for specific portfolio assets or classes of assets.” Furthermore, the Board made no attempt to provide substantive guidance beyond the Valuation Procedures. As a result, the SEC determined that the Board was liable pursuant to Section 9(f) of the 1940 Act for causing the Funds to violate Rule 38a-1.

In addition to the Board failing to implement meaningful procedures to establish fair value, as the SEC noted in the Order, the Board failed to provide proper oversight of third parties calculating the valuations. While boards are responsible for determining fair value of fund assets, boards may delegate the calculation of fair value so long as the directors implement procedures to provide guidance and oversight. Here, the SEC determined that the Board failed to fulfill these responsibilities. The SEC stated in the Order that the Valuation Committee and fund accounting employees of Morgan Keegan & Company, Inc., an affiliate of Morgan Keegan (“*Fund Accounting*”), had developed an unreasonable methodology for determining fair value, which included failing to use pricing models or engage in sufficient analysis or tests to validate prices. In addition, Fund Accounting often left fair value at cost unless a sale or price confirmation indicated a greater than 5% variance of the asset value. Fund Accounting also routinely accepted valuations provided by the portfolio manager of the Funds without question and engaged in smoothing prices by using preplanned daily reductions in asset values over a period of days or weeks. As a result of these practices, the net asset values of the Funds were

often incorrect, leading to inaccurate prices for sales, redemptions and repurchases of the Funds' shares.

Notably, although the Board was provided some quarterly reports regarding fair valuation determinations, including a report from the Valuation Committee, fair valuation forms, and security sales reports for each Fund, the information was inadequate in discussing the processes used to determine fair value and the Board failed to request additional information or make a meaningful effort to understand the methodology used by the Valuation Committee. Significantly, the SEC noted that the Board never followed up on any information related to the basis for the values assigned to the assets of the Fund, which "limited the [Board's] ability to (a) review carefully the findings of the Valuation Committee and, (b) satisfy themselves that all relevant factors had been considered." As a result, the SEC determined that the Board failed to design and oversee procedures to ensure accurate valuation of the portfolio securities of the Funds.

Increased Director Scrutiny

The proceedings against the Board were the second set of sanctions against independent directors this year for alleged failures of oversight. In May, the SEC also censured directors of Northern Lights Fund Trust for causing false or misleading disclosures related to Section 15(c) advisory contracts. The Northern Lights Fund Trust settlement order is available [here](#). These recent settlements suggest an increased scrutiny of directors by the SEC.

In light of the recent SEC settlements, directors may consider reviewing practices and policies relating to matters including:

- Implementation of valuation factors and methodologies for pricing commonly held securities;
- Notification of directors in the event of material pricing changes;
- Directors' access to fund libraries, portals or other similar records in the event of issues or questions involving fund pricing or asset valuation arise;
- Oversight of delegated tasks related to valuation duties, including calculations of fair value and procedures related to calculating and reporting pricing changes; and
- Directors' discussions with third parties regarding pricing, such as independent auditors, pricing services and legal counsel.

For More Information

To discuss any of the topics covered in this Client Alert or additional measures that directors can take in an effort to minimize liability related to valuation responsibilities, please contact an attorney in our Investment Management Group or visit us at chapman.com.

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