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SEC Takes Aim at Fund Directors Over Valuation Process: A Look at *In re J. Kenneth Alderman et al.*

ROSE F. DIMARTINO, MARGERY K. NEALE, AND MARIA R. GATTUSO

A recent settlement underscores the SEC's view that the ultimate responsibility for valuation matters rests with the board.

Directors of mutual funds and closed-end funds have taken note of the recent settlement of an SEC enforcement action against fund directors — and rightly so. In the settlement, the SEC takes aim at how the directors — the independent directors as well as the interested directors — satisfied their statutory obligation to determine the fair value of complex structured instruments held by the funds during what is acknowledged to be an especially challenging time to value those types of instruments — the credit crisis of 2007/2008. The long-anticipated settlement of this SEC enforcement proceeding highlights the SEC's scrutiny of a fund's valuation process and the board's role in that process.

In *In re J. Kenneth Alderman et al.*, the SEC alleged that the former directors failed to adopt, implement and oversee reasonable valuation procedures during the period from January to August 2007.¹ The former directors served on the boards of four closed-end investment companies and one open-end mutual fund with three series, all of which were heavily invested in below investment-grade debt securities backed by subprime mortgages for which market quotations were not readily available. The Settlement Order, dated

The authors all are partners in the Asset Management Group in the New York office of Willkie Farr & Gallagher LLP. They can be reached at rdimartino@willkie.com, mneale@willkie.com, and mgattuso@willkie.com, respectively.

June 13, 2013, found that the former eight directors (which included all of the independent directors as well as the interested directors) caused the funds' violations of Rule 38a-1 under the Investment Company Act of 1940, which requires funds to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws by the funds.² The individuals were ordered to cease and desist from committing or causing any violations of the Rule, but no monetary penalties were imposed upon the former directors under the Order.³

While many of the facts alleged in the initial proceeding⁴ brought against the former directors and in the Order are substantially similar, the Order narrowed the allegations of the directors' violations of law, finding only that the former directors caused the funds to violate Rule 38a-1 under the 1940 Act, and did not include findings that the former directors engaged in conduct resulting in three other violations alleged in the initial proceeding. The original allegations included that the former directors:

- Caused the open-end funds to violate Rule 22c-1 under the 1940 Act, which makes it unlawful for a registered investment company to issue, sell or redeem securities except at a price based on current NAV;
- Caused the funds to violate Rule 30a-3(a) under the 1940 Act, which requires the management of a registered investment company to maintain internal control over financial reporting; and
- Willfully caused to be made in a registration statement, filed with the SEC under the 1940 Act, a false or misleading statement with respect to a material fact or omitted to state in such registration statement a material fact required to be stated therein.

THE FUNDS' FAIR VALUATION PROCEDURES AND ALLEGED PRACTICES

Under the 1940 Act, a fund's board is required to determine in good faith a fair value for securities for which market quotations are not readily available.⁵ The Order states that between January 2007 and August 2007, fair-valued securities (including securities backed by subprime mortgages)

constituted the majority, and in most cases over 60 percent, of the funds' net asset values (NAVs). The former directors delegated the task of fair valuation to the funds' investment adviser, which further delegated the task to its Valuation Committee. While confirming that directors "may appoint persons to assist them in the determination of [fair] value, and to make the actual calculations pursuant to the board's direction," the Order indicates that the former directors' actions after delegation were insufficient:

The [d]irectors did not specify a fair valuation methodology pursuant to which the securities were to be fair-valued. Nor did they continuously review how each issue of security in the [f]unds' portfolios were being valued. The [d]irectors delegated their responsibility to determine fair value to the Valuation Committee of the investment adviser to the [f]unds, but did not provide any meaningful substantive guidance on how those determinations should be made. In addition, they did not learn how fair values were actually being determined. They received only limited information on the factors considered in making fair value determinations and almost no information explaining why fair values were assigned to specific securities.

Though the funds' Policy and Procedure Manual listed factors to be considered in the fair valuation process, the Order states that the "factors ... were copied nearly verbatim" from an SEC release,⁶ without any "meaningful methodology or other specific direction on *how* to make fair value determinations for specific portfolio assets or classes of assets." (emphasis in the original) The SEC gives the following examples:

[T]here was no guidance in the Valuation Procedures on how the listed factors should be interpreted, on whether some of the factors should be weighed more heavily or less heavily than others, or on what specific information qualified as "fundamental analytical data relating to the investments." Additionally, the Valuation Procedures did not specify what valuation methodology should be employed for each type of security or, in the absence of a specified methodology, how to evaluate whether a particular methodology was appropriate or inappropriate. Also, the

Valuation Procedures did not include any mechanism for identifying and reviewing fair-valued securities whose prices remained unchanged for weeks, months and even entire quarters.

The Order describes in substantial detail weaknesses that the SEC observed in *management's* fair valuation process. For example, in addition to the above, the Order also states that:

- Instead of using a reasonable method to determine fair value, the adviser's Valuation Committee typically marked fair-valued securities at the original purchase price, unless a sale or a month-end price confirmation changed the price by 5 percent or more;
- The funds' portfolio manager repeatedly contacted fund accounting and provided price adjustments for particular securities;
- The adviser generally obtained month-end price confirmations from broker-dealers for a "random sample" of the fair-valued securities; the price confirmations "were essentially opinions on price from broker-dealers, rather than bids or firm quotes"; and because the confirmations were obtained several weeks after the month-end, they could not have sufficed as the primary daily valuation method for the open-end funds or for the closed-end funds' daily publication of their NAVs;
- A provision in the funds' Valuation Procedures, which permitted the adviser to override a price obtained from a third party only when it had a "reasonable" basis to believe it did not accurately reflect the security's fair value was wrongly interpreted to allow the portfolio manager to arbitrarily set values, without a reasonable basis and in a way that postponed the declines in the funds' NAVs; and
- Fund accounting engaged in smoothing prices (using preplanned daily reductions in the value provided by the funds' portfolio manager to gradually reduce, over days or weeks, a bond to its proper valuation).

The Order is also critical of the fair value reports provided to the former directors and what the SEC observed as the former directors' resultant failure to understand what methodology was being used by the Valuation Commit-

tee to fair value particular securities. The Order notes that the funds' Valuation Procedures did not require the directors to ratify any fair value determinations made by the investment adviser, and that they, in fact, did not ratify any such determinations.

The Order states that independent auditors audited the funds' financial statements, provided unqualified opinions, and advised the former directors that the Valuation Procedures were appropriate and reasonable. However, presumably to address an argument that the former directors reasonably relied on the audit opinions rendered during the period in question, the Order notes that the auditors were not retained to opine on the funds' internal controls, and the audits did not provide the former directors with sufficient information about the valuation methodologies actually employed by the adviser's Valuation Committee to satisfy their obligations. As a result, the Order states that the auditors did not advise the former directors in any meaningful detail as to what pricing methodologies were actually being employed.

THE ROLE OF THE BOARD AS GLEANED FROM THE ORDER

The Order discusses the responsibilities of fund boards with respect to valuation. It states that funds are required by Rule 38a-1 under the 1940 Act to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws by the funds, including fair valuation policies and procedures.⁷ The Order states that “[i]t is the responsibility of a fund's board to ensure that the fund fulfills these obligations, particularly with respect to policies and procedures concerning the determination of fair value.” The Order notes that a board's “explicit statutory responsibilities with regard to the determination of the fair value of securities for which market quotations are not readily available are set forth in the definition of ‘value’ in Section 2(a)(41)(B) of the [1940] Act.” That section defines “value,” with respect to securities and assets of registered investment companies for which market quotations are not readily available, as “fair value as determined in good faith by the board of directors.”

The Order also discusses the guidance provided by ASR 118, stating that in that 1970 release, the SEC emphasized that it is the responsibility of the fund's board to determine fair values and that, even though the board may

seek assistance from others, it remains the board's duty (1) to establish the fair value methodology to be used, and (2) to continuously review *both* (a) the appropriateness of the methods used to value each security and (b) the valuation findings resulting from such methods. The Order also cites to a 1984 enforcement proceeding against a fund board that had not properly valued oil and gas interests,⁸ stating that ASR 118 and the 1984 proceeding make clear that "the ultimate responsibility for determining fair value lies with a fund's board of directors, and that this responsibility may not be delegated away." The Order notes that while a board may assign to a separate valuation committee the task of calculating fair values pursuant to board-approved valuation methodologies, "each director retains responsibilities to be involved in the valuation process and may not passively rely on valuations provided by such a committee."

In the instant proceeding, the former directors were deemed to have failed to exercise their responsibilities with regard to the adoption and implementation by the funds of procedures reasonably designed to prevent violations of the federal securities laws. The Order states that in connection with determining fair values:

[the former directors] did not calculate the valuations themselves, and neither established clear and specific valuation methodologies nor followed up their general guidance to review and approve the actual methodologies used and the resulting valuations. Instead, they approved policies generally describing the factors to be considered but failed to determine what was actually being done to implement those policies.

The SEC found that "[a]s a result, [the funds] implemented deficient procedures, effectively allowing the [p]ortfolio [m]anager to determine valuations without a reasonable basis." These failures were considered to be particularly significant given the substantial percentage of the portfolios of each fund that were fair-valued securities.

The SEC did not provide any guidance as to how the former directors should have "established" the specific "methodologies" for fair valuing securities for which market quotations are not readily available. Directors are not valuation experts and typically rely on management to recommend such

methodologies. As a result, it would seem that the real focus of the criticism was the process surrounding the board's oversight of the fair valuations determined by management.

The Order serves as an important reminder that the SEC remains keenly focused on the responsibility of fund directors in connection with the fair valuation of securities. While an enforcement action involves a particular context and should not be the means for the SEC to deliver guidance with respect to a fund board's role in the fair valuation process, the Order confirms that fund boards may delegate fair valuation responsibilities. It also indicates that if such delegation occurs, the board should, in the SEC's view, either establish "clear and specific valuation methodologies" to be followed by management or "review and approve the actual methodologies used and the resulting valuations."

While the Order identifies where the SEC thinks the Board fell short, it is not specific enough to provide definitive guidance applicable generally to valuation practices. Among the unanswered questions are:

- How frequently should a board review the methodology used and fair values determined to meet the standard of "continuous" review? Are there circumstances in which "continuous" review requires boards (or committees thereof) to function in "real time" to approve a new or changed methodology or price before it is used?
- What level of board understanding is required of the more esoteric "methodologies" used to price certain instruments?
- What reports on fair values suffice to satisfy the board's oversight role on fair values and does that vary based on the amount or type of fair-valued securities held by a fund?
- How can boards appropriately utilize fund auditors to support them in their oversight role with regard to valuation?

Directors will continue to grapple with these and other questions raised by this proceeding as they await further promised SEC guidance. The Order underscores, however, the SEC's view that the ultimate responsibility for valuation matters rests with the board.

NOTES

¹ *In the Matter of J. Kenneth Alderman, CPA, et al.*, Inv. Co. Act Rel. No. 30557 (Jun. 13, 2013). In June 2011, the funds' investment adviser settled an administrative proceeding arising out of the same facts in which, among other things, it was charged with fraud for failing to disclose to the funds' boards that it was not complying with the funds' stated valuation procedures. *In the Matter of Morgan Asset Management Inc., et al.*, Inv. Co. Act Rel. No. 29704 (Jun. 22, 2011).

² This is the second recent enforcement proceeding brought and settled by the SEC finding that, among other things, fund directors caused a registered fund to violate Rule 38a-1 under the 1940 Act. *See In the Matter of Northern Lights Compliance Services, LLC, et al.*, Inv. Co. Act Rel. No. 30502 (May 2, 2013).

³ The individuals consented to the entry of the Order without admitting or denying any of the findings, except as to jurisdiction.

⁴ *See In the Matter of J. Kenneth Alderman, CPA, et al.*, Inv. Co. Act Rel. No. 30300 (Dec. 10, 2012).

⁵ Section 2(a)(41)(B) of the 1940 Act.

⁶ Valuation of Portfolio Securities, Accounting Series Rel. No. 118 (Dec. 23, 1970) ("ASR 118").

⁷ The adopting release for Rule 38a-1 included pricing of portfolio securities and fund shares as one of the "critical areas" that the SEC expected funds' and service providers' compliance policies and procedures to follow and stated that Rule 38a-1 requires funds to adopt valuation policies and procedures. Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Inv. Co. Act Rel. No. 26229 (Dec. 17, 2003).

⁸ *In the Matter of Seaboard Associates, Inc.*, Inv. Co. Act Rel. No. 13980 (Apr. 16, 1984).