

SEC Charges Fund Independent Directors on Valuation of Portfolio Securities

December 12, 2012

December 12, 2012 -- The SEC has announced charges against former investment company directors for violating their duties to price portfolio securities under the Investment Company Act of 1940 ("ICA"). Investment Company Act of 1940 Release No. 30300 / December 10, 2012 ("Order"). The SEC ordered a hearing before an administrative law judge to take evidence on the questions raised, including, principally and briefly, whether the directors' conduct caused the companies to violate ICA:

- Rule 22c-1 by selling and redeeming shares at an incorrect net asset value;
- Rule 30a-3(a) by failing to maintain internal control over financial reporting; and
- Rule 38a-1 by failing to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws.

The SEC Order is noteworthy, because it appears to:

- charge directors for conduct in an uncertain legal area of portfolio securities valuation, where the SEC has promised, but failed, to provide greater guidance;
- constitute a rare action against *independent* directors; and
- impliedly question the designation of persons without professional licenses as audit committee financial experts.

Consequently and wholly aside from the ultimate outcome of the SEC's charges, investment companies and their sponsors and investment advisers may find it advisable to review board portfolio securities valuation policies and procedures and board designation of audit committee financial experts. **A. Situation** The factual situation described in the SEC Order happened in 2007 and was as follows. The investment companies involved were both open-end and closed-end companies (together, "funds"). Significant portions of the funds' portfolios contained below-

investment grade debt securities, some of which were backed by subprime mortgages, for which market quotations were not readily available. The Boards had delegated their responsibility to determine fair value to a valuation committee. The committee was comprised of employees of the funds' investment adviser. Certain facts and circumstances, such as the following, may have distinguished this situation from others, leading the SEC to bring the charges:

- securities without readily available market quotations comprised a "majority of Fund assets";
- the valuation methodology followed did not use a "pricing model" and did not "analyze future cash flows";
- prices for fair-valued securities "remained unchanged for weeks, months and even entire quarters"; and
- even after the SEC staff had "contacted" the directors with "concerns," the directors "still never asked specific questions about how the Funds' assets were being valued and how those values were being tested."

The SEC Order notes that the "SEC and other regulators previously charged the funds' managers with fraud, and the firms later agreed to pay \$200 million to settle the charges." The parties reached this agreement in 2011. At the time, the SEC did not state that it was considering bringing charges against the directors. Indeed, what the SEC said then could be read to conclude that the directors had been defrauded. **B. Discussion** Fund board responsibility regarding portfolio securities valuation has been uncertain. With respect to portfolio securities and assets for which market quotations are not readily available, the ICA, in effect, requires a fund board to determine "fair value" in "good faith." However, the SEC has long recognized that, realistically, fund boards may not have the expertise to assign specific dollar values to particular securities. Accordingly, the SEC, in the words of the Order, has stated that "the board may appoint persons to assist them in the determination of such value, and to make the actual calculations pursuant to the board's direction." However, as the SEC also states in the Order, the board must:

- specify a "meaningful" and "substantive" fair valuation methodology;
- make a "meaningful effort" to "learn" how the board's delegate is "actually" determining the fair values of "particular fair values" reported to the board; and
- continuously review the "appropriateness" of the methodology used in valuing each issue of security.

Industry practice regarding board approval of portfolio securities valuations has varied. Some boards, for example, simply receive valuation reports, but do not affirmatively approve them. Other boards adopt resolutions approving valuation reports in one form or another, for example, either in general or in terms of specific dollar valuations. The SEC staff, from time to time over the past several years, has announced that the SEC would provide more specific guidance for valuation of

portfolio securities. However, at the moment, the SEC has merely posted on its website a list of past pronouncements that it has made. Generally speaking, the SEC and its staff have not publicly questioned the capability or credentials of audit committee financial experts. The SEC Order recites the fact that three of the six independent directors whom the board designated as audit committee financial experts "never held any professional licenses." The SEC Order doesn't say anything more on the subject, but the SEC could address the subject during the hearing.

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