

MEMO# 27317

June 18, 2013

Former Mutual Fund Directors Agree To Settle Claims That They Failed To Properly Oversee Asset Valuation

[27317]

June 18, 2013

TO: FIXED-INCOME ADVISORY COMMITTEE No. 13-13
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 15-13 RE: FORMER MUTUAL FUND DIRECTORS AGREE TO SETTLE CLAIMS THAT THEY FAILED TO PROPERLY OVERSEE ASSET VALUATION

The SEC and eight former directors have settled an enforcement proceeding initiated by the SEC against the directors in December 2012 for failing to properly oversee asset valuation of five open- and closed-end funds during the period from January to August 2007. [\[1\]](#) In the settled order, the SEC found that the directors caused the funds to violate Rule 38a-1 under the Investment Company Act of 1940—the fund compliance program rule—and were ordered to cease and desist from committing or causing any violations or future violations of the rule. The SEC and other regulators previously charged the funds’ adviser and others, and the firms later agreed to pay \$200 million to settle charges related to that conduct.

The following is a summary of the SEC’s order.

Findings [\[2\]](#)

Between at least January 2007 and March 2007, significant portions of the funds’ portfolios contained below-investment grade debt securities for which market quotations were not readily available. Under the 1940 Act, those securities were required to be valued at fair value as determined in good faith by the directors. Fair valued securities made up a majority—in most cases upwards of 60%—of the funds’ net asset values (NAVs) during the relevant period.

The directors delegated their valuation responsibilities with minimal guidance. The funds’ valuation policies delegated to the adviser the responsibility for carrying out certain functions relating to the valuation of portfolio securities and listed various general and specific factors that the adviser’s valuation committee was to consider when making fair valuation determinations. Other than listing the factors to be considered, which were copied nearly verbatim from the Accounting Series Release No. 118, [\[3\]](#) the procedures provided no meaningful methodology or specific direction on how to make fair value

determinations for specific portfolio assets or classes of assets.

The adviser's valuation committee, which consisted of fund officers and fund accounting employees, was responsible for overseeing the fair valuation process. In practice, the task of assigning fair values on a daily basis was performed by fund accounting. In determining fair value, fund accounting did not use any reasonable analytical method to arrive at fair value. Fund accounting typically set a security's initial fair value price as its purchase price and thereafter left that fair value unchanged unless a sale or price confirmation indicated a more than 5% variance from the previously assigned fair value. In addition, the portfolio manager repeatedly contacted fund accounting and provided price adjustments for particular securities.

Shortly after each month end, fund accounting selected and sought price confirmations for a random sample of the funds' securities that were required to be fair valued, except for March and June when, in connection with annual audits, confirmations were sought by the auditors for 100% of the fair valued securities. The price confirmations were essentially opinions on price from broker-dealers, rather than bids or firm quotes. In the event a price confirmation indicated a more than 5% variance from the previously assigned fair value, fund accounting effectively allowed the portfolio manager to determine the fair value. The portfolio manager arbitrarily set values without a reasonable basis and did so in a way that postponed the degree of decline in the NAVs of the funds which should have occurred during the relevant period. Fund accounting also engaged in smoothing prices (using preplanned daily reductions in value provided by the portfolio manager to gradually reduce, over days or weeks, a bond to its current proper valuation).

During the relevant period, the directors did not determine what methodology was actually used by fund accounting and the valuation committee to fair value particular securities or types of securities. The information and reports provided to the directors at their board meetings did not provide sufficient information for the directors to understand what methodology was being used by fund accounting to fair value particular securities. For example, at each quarterly board meeting, the directors received a list of the funds' portfolio securities that were required to be fair valued and the fair values assigned to each security. However, the information provided did not identify the type of security, the basis for a particular assigned value, or whether that price had changed from prior quarters.

Outside counsel advised the directors in connection with the adoption of the written valuation procedures. Further, independent auditors audited the funds' financial statements, provided unqualified opinions, and advised the directors that the valuation procedures were appropriate and reasonable. The auditors were not retained to opine on the funds' internal controls, however, and the audits did not provide the directors with sufficient information about the valuation methodologies actually employed by fund accounting and the valuation committee. As a result, the auditors did not advise the directors in any meaningful detail as to what pricing methodologies were actually being employed.

Responsibilities of the Board

Funds are required to adopt and implement policies and procedures reasonably designed to prevent violations of the securities laws, including fair valuation policies and procedures.

[\[4\]](#) It is a 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.

In ASR 118, the SEC emphasized:

it is the responsibility of a fund's board of directors to determine fair values and cautioned 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 issue of security and the valuation findings resulting from such methods.

In a 1984 enforcement action, which found fault with a fund board that had not properly valued oil and gas royalty interests, the SEC stated that while it "recognizes the difficulties inherent in the valuation of [such] interests, directors have an affirmative responsibility to keep informed of developments which materially affect those assets not having a readily ascertainable market value." [\[5\]](#)

In ASR 118 and the enforcement case, the SEC clearly stated that:

the ultimate responsibility for determining fair value lies with a fund's directors, and that this responsibility cannot be delegated away.

In connection with determining fair values, the 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. As a result, fund accounting implemented deficient procedures, effectively allowing the portfolio manager to determine valuations without a reasonable basis. In this regard, the directors 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.

Amy B.R. Lancellotta
Managing Director

endnotes

[\[1\]](#) See In the Matter of J Kenneth Alderman, CPA, et al, Investment Company Act Release No. 20557 (June 13, 2013).

[\[2\]](#) The parties neither admitted nor denied the findings in the order, except as to the SEC's jurisdiction over them and the subject matter of the proceedings, which were admitted.

[\[3\]](#) Accounting Series Release No. 118 (Dec. 23, 1970) ("ASR 118").

[\[4\]](#) Rule 38a-1 under the 1940 Act.

[\[5\]](#) See In the Matter of Seaboard Associates, Inc., Investment Company Act Release No. 13890 (Apr. 16, 1984).

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.