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Mutual Fund Directors Digest

Focus on fair valuation: Implications for directors from the Morgan Keegan case

Background

In June 2013, the U.S. Securities and Exchange Commission (SEC) issued its findings against the former directors (Morgan Keegan directors) of the Morgan Keegan funds in connection with the fair valuation of the funds' securities (http://www.sec.gov/litigation/admin/2013/ic-30557.pdf).[1] The funds heavily invested in below investment grade debt, with the majority of the funds' assets invested in structured products including those backed by subprime mortgages. Often a difficult asset class to value, these holdings became more challenging to price during the relevant period of January through August 2007 due to extreme market conditions, including reduced liquidity and price volatility.

The SEC has used the case as a platform to reiterate its long-standing position that fund directors are ultimately responsible for fair valuations and that directors must actively ensure that fair valuations are appropriate and related processes are working as intended.[2] In our opinion, the case — combined with other recent SEC communications[3] — sends a clear message that the SEC will remain focused on valuation issues, making this an opportune time for directors to revisit their funds' valuation practices and their oversight processes governing fair value decisions.

Admittedly, deciphering key takeaways through the lens of an enforcement action can be challenging. In this regard, the actions that may be appropriate to consider largely depend on the specific circumstances of particular fund groups, including the types of investments, pricing sources utilized, the nature of fair valuations, and the overall valuation governance structure, among others.

In this Digest, we identify important themes from the case for directors to consider, drawing on our industry experience and our understanding of fair valuation practices from our annual Fair Value Pricing Survey. We focus our insights on practical implications, including those relative to fair value methodologies, policies and procedures, stale valuations, pricing overrides, and board reporting.

Fair value methodologies and written policies and procedures, including stale prices

In the Morgan Keegan case, the SEC found that the funds' valuation procedures relied on boilerplate-type factors taken directly from Accounting Series Release 118 (ASR 118).[4] These factors included matters such as fundamental analytical data relating to the investment, the market for the securities, and the issuer's financial statements. The SEC found that, beyond these factors, the procedures provided no meaningful methodology or other specific directions on how to make fair value determinations for specific portfolio assets or classes of assets. The SEC also found other issues with the funds' procedures, including that the procedures did not include any mechanism for identifying and reviewing fair valued securities whose prices remained unchanged (so-called stale prices) for weeks, months, and entire quarters. Finally, the SEC found that the procedures did not require the Morgan Keegan directors to ratify fair value determinations, and that the Morgan Keegan directors did not ratify such valuations in practice.

Considerations for directors: In our experience, fund valuation procedures often include the fair valuation factors provided in ASR 118; as the SEC indicated in adopting ASR 118, these factors can be relevant to fair value determinations. In light of the case, however, directors should consider whether additional guidance should be provided in their funds' documented procedures. Such guidance may include, for example, identifying which factors should be given greater weight in fair valuing certain investment types and how to use the factors to determine the fair value of a security or asset class. Directors should also determine if their funds' procedures address stale prices. Guidance, for example, may include when fair valuations will be considered stale (e.g., by establishing a specific number of days during which valuations have not changed) and the actions to be taken by management to reassess

[1] The SEC found that the Morgan Keegan directors caused the funds to violate Rule 38a-1 of the Investment Company Act, which requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for the oversight of compliance by the investment adviser. The case against the Morgan Keegan directors follows an SEC settlement with management concerning the funds' valuation practices. See http://www.sec.gov/litigation/admin/2013/ic-30557.pdf.

[2] See section 2(a)(41)(B) of the Investment Company Act, which requires the board to determine a security's fair value in good faith when market values are not readily available, and Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970) regarding the SEC's interpretation of this requirement.

[3] See National Exam Program, Office of Compliance Inspections and Examinations, Examination Priorities for 2013, February 21, 2013.

[4] See note 1.

the appropriateness of the assigned fair valuations, such as reviewing data from media sources, reviewing trading activity of comparable securities, assessing the movement of relevant indices, or performing price comparisons using approved secondary sources.

Importantly, directors should consider procedural requirements governing their direct involvement in fair valuation pricing. This may include board approval of fair value pricing methodologies in advance, real time involvement in fair value decisions, and/or ratification of specific fair valuations. The SEC staff has noted in the past that the level of director involvement in fair value determinations is often determined by whether fund valuation procedures are detailed or broad based in nature, with the latter requiring greater and more timely director involvement in fair value decisions and vice versa.

Adherence to procedural requirements in practice

As is common in enforcement actions, the SEC found that management did not follow the funds' written procedural requirements, including the requirement for the Morgan Keegan directors to receive written explanatory information in support of the fair valuations assigned. The SEC also found that while the funds' procedures required fair value decisions to be made by a management valuation committee, fair values were assigned in practice by the fund accounting group with significant influence from the portfolio manager.

Considerations for directors: The case stands as a reminder that documented procedures must be followed in practice. Directors should consider reviewing or performing a walkthrough with management of the procedural requirements attending fair valuation decisions, including relevant internal controls and action/decision points. This process can both facilitate director understanding of their funds' specific processes and serve to confirm the application of the procedures in actual practice. As appropriate, procedures should be updated and refined to reflect the valuation processes followed in practice.

Board reporting, including price overrides

In the case, the SEC found that fair valuation decisions were made with significant input from portfolio management. In this regard, the SEC found that the Morgan Keegan directors did not receive information on management "overrides" of prices provided by a pricing service or broker-dealers. More broadly, the SEC found that the information and reports provided to the board did not provide sufficient information for the Morgan Keegan directors to understand what methodologies were used to fair value the funds' securities.

Considerations for directors: Consistent with the findings in the case, directors may want to assure that they receive sufficient information regarding securities that are fair valued including, for example, the type of security fair valued and the methodology used to determine the fair valuation. Directors may want to specifically evaluate the reports they receive relative to price overrides, including whether a fair valuation reflects a price override and the reason(s) for the override. Directors may also want to evaluate additional board reports such as, for example, those relating to the percentage and number of fair valued securities for each fund, back-testing results when fair valued securities are sold, and identifications of any "red flags" that would prompt greater director scrutiny such as market or political instability and industry trends that impact fair valuations.

In closing

With fair valuation likely to remain in the spotlight, we expect directors across the industry to continue to review the findings of the case, benchmark their funds' fair valuation processes against it, and make a determination whether to revise their fair valuation practices. The Morgan Keegan case makes it clear that the SEC expects directors to understand how fair value prices are being determined and to provide clear guidance relative to fair value decisions.

With ten years of experience and data from our Fair Value Pricing Survey, our Deloitte professionals are happy to answer your questions and provide more information regarding this important topic.

If your fund complex would like to participate in the 11th Annual Fair Value Pricing Survey, please contact any of the Deloitte professionals below.

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