

Beyond Morgan Keegan – Valuation, Compliance, and Enforcement Issues for Directors

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Panelists

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Agenda

- Lessons Learned from Morgan Keegan
- Impact of PCAOB Activities on Valuation Practices
- SEC Enforcement Actions Against Directors under the Funds Compliance Rule (Rule 38a-1)
- Evolution of Board Oversight of Fund Compliance

Lessons Learned from Morgan Keegan Regarding Board Oversight

- Boards are actively reviewing fair valuation practices
- Directors should understand who is doing what (advisory personnel, pricing services, portfolio managers) – shared responsibility for education
- Directors should understand the fund's pricing methodologies

Lessons Learned from Morgan Keegan Regarding Board Oversight (cont'd)

- Directors can still delegate and rely on experts;
Typically, do not need to hire experts
- Use of pricing/valuation committees
- Use of pricing services
- Board reports must provide appropriate information for boards to fulfill its oversight responsibility

Lessons Learned from Morgan Keegan: Fair Valuation Policies and Procedures

- Fair Valuation Policies and Procedures
 - First and foremost, policies and procedures must be presented in an understandable way
 - Policies and procedures need to address conflicts of interest
 - Valuation procedures need to make clear to whom responsibility has been delegated and establish clear oversight roles

Lessons Learned from Morgan Keegan: Fair Valuation Policies and Procedures (cont'd)

- Valuation procedures should address methodologies for pricing portfolio securities, testing stale prices, use of broker quotes and overrides
- Flexibility needed for changes in economic climate or new and unusual circumstances
- Annual review or more frequent, as needed

SEC Guidance??

- Is further SEC guidance needed? If so, in what areas?
 - Level of board involvement? SEC's expectations?
 - Ability of board to rely on the CCO, counsel, auditor?
 - How to address methodologies in procedures?
 - Scope of ratification?
- See Appendix (slides 20-25) for a summary of relevant law and guidance regarding fair valuation

PCAOB Inspection Themes and Resulting Changes

- Auditor valuation procedures have been a significant focus of the PCAOB and is an area that frequently produces comments in Part 1 of PCAOB inspection reports over Independent Audit Firms
- The audit profession has made enhancements to address concerns raised during inspections, including:
 - Performing additional due diligence procedures over third party pricing vendors
 - Emphasizing that auditors evaluate all pricing information obtained from independent sources rather than utilizing the price closest to the issuer's valuation
 - Increased use of internal valuation specialists to assist in developing independent prices

SEC Enforcement Actions; Rule 38a-1

- Fund boards have recently been targets in SEC enforcement proceedings where settlements have turned on Rule 38a-1 violations
 - Morgan Keegan (June 2013) – Settlement against directors included violation of Rule 38a-1 for failure to implement and oversee adequate valuation policies and procedures
 - Northern Lights (May 2013) – Board failed to approve the advisers’ policies and procedures in a manner consistent with Rule 38a-1

Fund Compliance; 1940 Act Rule 38a-1

- Adopted in 2003, Rule 38a-1 requires funds and their investment advisers, in part, to:
 - adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws
 - review those policies and procedures annually for their adequacy and the effectiveness of their implementation
 - fund directors to adopt fund policies and procedures and approve policies and procedures of service providers, including investment adviser, underwriter, transfer agent and administrator
- See Appendix (slides 26–28) for a discussion of the areas a fund’s and adviser’s compliance procedures should cover

Board Roles and Responsibilities under Rule 38a-1

- Factors the SEC's release proposing Rule 38a-1 indicated boards should consider in approving a service provider's compliance policies and procedures:
 - nature of the fund's exposure to compliance failures
 - any recent compliance experiences, which may demonstrate weaknesses
 - best practices used by other fund complexes
- Boards may consult with fund counsel, compliance specialists and other experts familiar with compliance practices

Rule 38a-1 and Morgan Keegan

- Complaint originally included charges concerning Rule 22c-1 (selling/redeeming shares at current net asset value), Rule 30a-3(a) (internal controls over financial reporting), Rule 38a-1 (failure to adopt and implement meaningful fair valuation methodologies and procedures)
- In June 2013, the proceeding was settled with the only violation being a violation of Rule 38a-1

Rule 38a-1 and Northern Lights

- Northern Lights structure as a multi-series platform
- Proceeding addressed both deficiencies in the 15(c) process, as well as deficiencies in the approval process relating to sub-adviser compliance policies and procedures
- Administrative and compliance services found to have violated record-keeping requirements, and requirement to send shareholders accurate reports; compliance service found to have violated Rule 38a-1

Rule 38a-1 and Northern Lights

- Directors found to have violated Rule 38a-1 by relying on representations about adequacy rather than summaries or actual procedures
- Directors failed to ensure that the series implemented their policies and procedures
- Directors also found to have violated Section 34 (b) in connection with the 15(c) process

What is the SEC signaling in this case?

- SEC is willing to bring cases for process failures (i.e., Rule 38a-1) even with no customer harm
- SEC is not afraid to bring cases with relatively weak facts (Northern Lights)
- Cases involving directors are of interest to the SEC; asking in possible enforcement actions, “Where was the board?”
- Compliance policies and procedures are under greater scrutiny

Evolution of Board Oversight of Fund Compliance

- Evolution of board oversight since implementation of the rule in 2004 and recent enforcement actions
- Evaluating a fund's compliance program and the CCO
- Revisions to policies and procedures to reflect how program works and to reflect current issues (e.g., Rule 2a-7, money market funds; valuation) and enforcement actions
- Addition of policies and procedures (e.g., derivatives, securities lending)
- Reports provided to the board
- CCO meetings with the board

Other Areas of Potential Focus

- Directors may want to review other policies and procedures required by Rule 38a-1 on which the SEC may focus next:
 - Pricing of fund shares
 - Identification of affiliated persons
 - Protection of non-public information
 - Compliance with fund governance requirements
 - Portfolio management (e.g., compliance with investment limitations and disclosures)
 - Trading (e.g., best execution, soft dollars)
 - Accuracy of disclosures to investors and prospects
 - Disaster recovery

TAKEAWAYS

- Understand the fund's fair valuation policies and procedures; seek assurances that they reflect actual practices
- Make sure reports and presentations are digestible and not data dumps
- Rule 38a-1: the SEC's new catchall in actions against directors; board actions in overseeing fund compliance are under greater scrutiny
- Never talk to the SEC without counsel present

APPENDIX

APPENDIX: Morgan Keegan; Summary of Relevant Law and Guidance

- Section 2(a)(41) of the Investment Company Act 7 of 1940 (“1940 Act”) defines “value” to mean:
 - with respect to securities for which market quotations are readily available, the market value; and
 - with respect to other securities and assets [for which no market value is readily available] fair value as determined in good faith by the board of directors
- Rule 2(a)(4) under the 1940 Act applies the same definition of “value” in defining “current net asset value.”

APPENDIX: Morgan Keegan; Summary of Relevant Law and Guidance

- Rule 22c-1 under the 1940 Act requires that shares of funds be sold and redeemed at their current net asset value at least once daily, Monday through Friday
- In 1969, the SEC issued ASR 113
 - Primarily addresses valuation with respect to restricted securities
 - States that formulas and other similar methods used to value restricted securities constitute fair value determination for purposes of Section 2(a)(41)
 - Discusses specific methods used to calculate valuation
 - First time the concept of a board's delegation of actual valuation calculations is discussed

APPENDIX: Morgan Keegan; Summary of Relevant Law and Guidance

- In 1970, the SEC issued ASR 118
 - Expanded on ASR 113 and provided more general guidance
 - Permits directors to appoint persons to assist them in the determination of “value” and to make the actual calculations pursuant to the directors’ direction
 - Provided general and specific factors regarding fair valuation determinations

APPENDIX: Morgan Keegan; Summary of Relevant Law and Guidance

- SEC letters to ICI (1999 and 2001)
 - 1999 letter:
 - Provided guidance on factors to consider when fair valuing a security in situations where exchanges or markets do not open
 - 2001 letter:
 - Discussed significant events that occur after closing market prices established but before NAV calculation

APPENDIX: Morgan Keegan Enforcement Action; Summary of Relevant Law and Guidance

- ASR 118 (1970)
 - Directors must satisfy themselves that all appropriate and relevant factors have been considered and determine method for arriving at fair value
 - Directors may appoint persons to assist in determination of fair value and make actual calculations pursuant to the board's direction
 - Directors must continuously review appropriateness of fair value methods
 - If technical assistance is requested from non-directors, directors must carefully review findings of those individuals

APPENDIX: Morgan Keegan; Summary of Relevant Law and Guidance

- SEC letter to ICI (1999) recognized burdens on boards
 - Acknowledged that most boards fulfill valuation obligations by reviewing and approving pricing methodologies
 - Methodologies may be formulated by fund boards
 - Methodologies are typically recommended and applied by fund management
 - “In reviewing and approving pricing procedures, boards should determine whether methodologies and procedures are reasonably likely to result in the valuation of securities at prices which the funds could expect to receive upon their current sale”

APPENDIX: Fund Compliance; 1940 Act Rule 38a-1

- SEC adopting release indicated fund compliance policies and procedures, at a minimum, should cover:
 - Valuation
 - Pricing of fund shares
 - Identification of affiliated persons
 - Protection of non-public information
 - Compliance with fund governance requirements
 - Market timing

APPENDIX: Fund Compliance; 1940 Act Rule 38a-1

- SEC adopting release indicated adviser compliance policies and procedures, at a minimum, should cover:
 - Portfolio management (e.g., compliance with investment limitations and disclosures)
 - Trading (e.g. best ex, soft dollars)
 - Accuracy of disclosures to investors and prospects
 - Safekeeping of client assets and data
 - Books and records
 - Disaster recovery
 - Other

APPENDIX: Fund Compliance; 1940 Act Rule 38a-1

- A fund's procedures must provide for the oversight of compliance by key service providers, including:
 - the fund's adviser(s)
 - principal underwriters
 - administrators
 - transfer agents (the "Service Providers")
- Fund boards must approve the policies and procedures of service providers