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What Boards Can Learn From the Morgan Keegan Case

BY THE INVESTMENT MANAGEMENT PRACTICE

On December 10, 2012, the Securities and Exchange Commission (the "SEC") charged eight former members of the board of directors (consisting of two "interested" and six independent directors) of the Morgan Keegan funds (the "MK Board") with a number of violations of the Investment Company Act of 1940, as amended (the "1940 Act"). These charges related to alleged failures by the MK Board in connection with their valuation oversight responsibilities for five funds that invested heavily in subprime mortgage-backed securities (the "MK Funds"). The action against the MK Board follows the settlement of a separate enforcement action, based on the same underlying facts, that the SEC brought against Morgan Asset Management, Inc. (the "Adviser"), Morgan Keegan & Company (the "Distributor"), the portfolio manager of the MK Funds, and the treasurer of the MK Funds. On March 27, 2013, the MK Board agreed to settlement terms with the SEC that resulted in a dismissal of the action against them. Details of the settlement have not yet been publicly disclosed.

As both of these actions are now concluded, it is appropriate to ask: *What can boards of directors ("Boards") learn from these cases?* Much has been written about the allegations in the two complaints. Rather than re-plow this ground, we will explore what changes to practices Boards might wish to consider going forward as a result of these actions.

Background

The Case against Morgan Keegan - On April 7, 2010, the SEC initiated enforcement proceedings against the Adviser, the Distributor, the portfolio manager of the MK Funds, and the MK Funds' treasurer, alleging fraud and failure to employ reasonable procedures to fair value certain securities backed by subprime mortgages held in the MK Funds ("Subprime MBS"). More specifically, the SEC alleged that from January 2007 to August 2007, the MK Funds, which contained considerable amounts (at times up to 60%) of Subprime MBS, were mispriced due to (i) the fraudulent actions of the portfolio manager in overriding price quotations and improperly influencing broker-dealers to change price confirmations provided to the MK Funds' accounting department and to its independent auditor, and (ii) the acts and omissions of the Adviser and the treasurer in failing to supervise the portfolio manager adequately, improperly permitting the portfolio manager to make price adjustments, and failing to employ reasonable valuation processes and practices. According to the complaint, these failures resulted in the MK Funds overstating their net asset values ("NAVs") over an extended period and caused substantial losses to the MK Funds' shareholders.

On June 22, 2011, the parties entered into a settlement in which the Adviser and Distributor agreed to pay $75 million in civil penalties, $25 million in disgorgement and interest, and an additional $100 million in connection with a related enforcement action brought by FINRA and a task force of state regulators. The portfolio manager was banned for life from working in the industry and the treasurer received a two-year ban.

It is important to note that, in the Complaint, the SEC states that the MK Board was defrauded by the Adviser and that the Adviser concealed these improper valuation practices from Board members.

The Case against the MK Board - Nearly a year-and-a-half after the settlement of the case against the Adviser, the SEC took the unusual step of instituting a separate proceeding against the MK Board. In this action, the SEC alleged that the MK Board violated the 1940 Act by failing to properly oversee the MK Funds' fair value process. The SEC claimed that while the MK Board had delegated its responsibility for fair valuation to the Adviser's Valuation Committee, the Board failed to provide any meaningful substantive guidance as to how fair valuation determinations should be made.

The SEC criticized the MK Funds' valuation procedures as being no more than restatements of prior SEC guidance, with no real mechanism for identifying and reviewing fair value situations, even for securities whose prices remained unchanged for several months or several quarters. The SEC alleged that the valuation procedures provided no real direction as to how the fair value process was actually to be conducted; for example, when price confirmations should be used, how frequently they should be requested, and how broker-dealers should be selected for price confirmation purposes. The SEC further alleged that the MK Board made no meaningful effort to understand how fair values were actually being determined, received only limited information on the factors employed by the Adviser's Valuation Committee in assigning fair values, received insufficient meaningful information to support valuation determinations, failed to understand the information provided to them, and failed to follow up on their own requests for explanations and clarifications of materials submitted to them.

The MK Board has emphatically denied these allegations. As noted above, the MK Board and the SEC have agreed to a settlement of this action, the terms of which are yet disclosed.

What Boards Can Learn From These Actions

As the industry awaits further long-promised guidance from the SEC on valuation, the Morgan Keegan cases have sparked much discussion in fund boardrooms. This SEC guidance, if and when issued, may address the SEC's views as to the specific role it expects fund Boards to play in the valuation process. In the meantime, we believe there are a number of practices Boards might consider based on the Morgan Keegan actions. While funds and Boards differ, several "best practices" can be gleaned from the SEC's allegations and the facts of the Morgan Keegan matters. Some of these practices are specific to valuation matters, but others are of more general applicability.

General Lessons

Understand the information provided to you, or "Beware the Dangers of the Data Dump."

The SEC alleged that the MK Board did not fully understand some of the valuation-related information provided to them in the Board materials. There is often an inclination among advisers and fund management to provide the Board with more, rather than less, information on a given topic. This tendency may spring from a sincere desire to be forthcoming, to demonstrate the quality and substance of the work that is performed in a given area, and to demonstrate to the Board that the

adviser or fund management is forthcoming and open. There are, however, issues that arise for Boards in taking this approach.

First, there is the issue of information overload. Boards need to keep laser-like focus on their oversight role and ensure that the information they receive appropriately serves them in this function. Board meetings are long, Board materials are voluminous, and the nature and scope of a Board's oversight responsibilities increases every day. Boards need to make a concerted effort to ensure that they have enough time and resources to perform their role, and that includes reviewing and understanding the information provided to them. Information should be provided in an efficient and useful manner and information that is not helpful to the Board's oversight role should be eliminated.

Second, more information may result in claims of imputed knowledge. Once information is provided, directors may be held responsible for understanding that information and taking action if appropriate. This is true even if the information is of a very technical nature, beyond the comprehension of most directors and other laypersons, or is provided in an abstract or unorganized manner where "none of the dots are connected." It is an unfortunate reality of litigation and enforcement actions that, hindsight being 20/20, once a problem has surfaced, a claim is often made that the problem should have been evident to the directors from the information they previously received; i.e., that the directors should have "connected the dots." If a director receives material that he or she does not understand, the director should make sure he or she gets an explanation.

To that end, Boards should consider a periodic review with their counsel of the Board materials to determine: (i) if information that is not being provided should be provided, (ii) whether certain information should be summarized by management in an overview memo that includes management's views as to the meaning or import of the information and a description of the back-up information not provided, and (iii) whether other information provided to the Board is unnecessary and should be eliminated or reworked to make it more meaningful and allow the Board meetings to be run more efficiently.

"Procedures" should be procedures, not legal summaries.

The SEC's allegations in the Morgan Keegan case included an allegation as to the deficiency of the MK Funds' valuation procedures. The SEC claimed that the procedures did little more than restate existing regulatory standards, providing no meaningful guidance to management as to how valuation was to be conducted. It is a reality that fund policies and procedures are often prepared by attorneys, and as such they often restate legal principles. In reality, policies and procedures should do far more than restate existing law.[1] Under Rule 38a-1 of the 1940 Act, the Board is required to adopt a compliance program that is "reasonably designed" to prevent violation of the securities laws. As such, the Board needs to ensure that these policies and procedures are robust and adequate to the task.

Boards, with their counsel and chief compliance officer, should ensure that fund compliance policies and procedures include a discussion of: (i) what the procedure is (not only what the law is), (ii) when and how the procedure is to be conducted and who is responsible for conducting it, (iii) how compliance with the procedure is to be monitored, and (iv) the reporting and escalation procedures.

Don't let sleeping dogs lie – follow-up, follow-up, follow-up.

Another SEC allegation in the Morgan Keegan case was that the MK Board did not follow-up on requests for information or explanations. Requests for additional information may arise orally during a

Board meeting or may appear in Board minutes, which often will indicate that the directors asked for certain additional information regarding a particular matter.

One "best practice" is for each Board to maintain a "follow-up" list that tracks requests for additional information. A point person should be named who takes responsibility for preparing and circulating the list. Often, the administrator or fund counsel is assigned that task. We also recommend that minutes are carefully reviewed to ensure that all requests for additional information reflected therein are on the follow-up list. As follow-up matters are completed, they should be checked off the list.

On Valuation Specifically

It's not so much daily pricing as it is fair value pricing.

The Board has a significant role to play in the area of pricing or valuation. A fund's pricing policies and procedures must necessarily address matters such as the selection and oversight of pricing vendors, foreign securities pricing, pricing tolerance bands, and stale pricing. However, it is in the area of fair value pricing that the greatest conflicts exist and where there is the greatest potential for mischief. As a result, it is the fair value process and fair value price determinations that warrant the greatest level of Board attention.

Boards should consider implementing a practice to undertake at least annually, and more frequently if necessary, a detailed review of the fund's pricing policies and procedures, paying particular attention to the fair value process. Boards should understand when a security will be fair valued, what the fair value process entails, and who is empowered to set, or override, prices. If broker confirmations are used, how are the brokers selected and are alternative pricing sources also available to validate prices? If a valuation committee exists, directors should understand who is on that committee and how it operates.

We also believe that Boards need to understand the methodology employed in each material fair value situation.[2] Board reports should discuss with some degree of specificity the methodologies used and factors considered in arriving at a fair value price. If pricing models or matrices are used, they should be explained in a plain-English manner and the Board should understand how methods and models/matrices are periodically tested for effectiveness.

While the Board need not be involved in establishing every fair value price, the Board should understand how the price was set, by whom and why. Boards should also review valuation practices with an eye toward conflicts of interest. What is the involvement in portfolio management in the process? Can portfolio managers override pricing determinations and if so, how is the inherent conflict which arises in that situation managed?

Board involvement needs to be ongoing – can't just "set it and forget it."

The specific level of a Board's involvement in the day-to-day valuation process is a matter of intense interest for Boards. It is hoped that the SEC's valuation guidance will provide more clarity in this area. In the meantime, it is clear that a practice of establishing a procedure and delegating implementation completely to the adviser is insufficient in the SEC's eyes.

We recommend that Boards work with their counsel to establish a level of ongoing valuation involvement that is appropriate for their particular circumstances. Of course, the nature of a fund's portfolio investments and the amount of securities that are typically subject to fair value pricing will play a critical role in the level of Board involvement required. In some cases this may call for the

establishment of a director valuation committee. Other cases may involve director participation in an adviser valuation committee. Still others may involve detailed quarterly reporting to the Board in lieu of the director's involvement in the daily fair value process.

Resist over-reliance on auditor verification.

Mutual fund auditors can play a helpful role in assisting the Board on valuation matters. They can also be a valuable source for "best practices" information. While auditors do perform a 100% price verification, and some employ pricing specialists to verify certain complex fair value prices, they do so only as of the year-end audit date. Therefore, these findings may have little import in relation to pricing that occurs during the rest of the year. As a result, directors should not over-rely on a clean audit opinion or a "no material weakness" internal control letter.

We recommend that the auditors be specifically asked to review and comment on the fund's valuation policies and procedures. In certain cases, it may also be appropriate to inform the auditors, before the fiscal year-end, of certain difficult fair value pricing situations and perhaps seek the input of the auditor's valuation specialist.

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[1] Indeed, since all funds are already subject to legal requirements, there is in fact no need to restate law in fund policies and procedures. Most fund policies and procedures do summarize applicable legal requirements as a drafting practice. In doing so, however, care must be taken that the fund does not inadvertently adopt standards that are more restrictive or different than legal requirements, for example, by adopting a policy or procedure that contains an incomplete or inaccurate description of the law.

[2] A material fair value event is a generally considered a fair value change that is significant enough to result in a change in the fund's NAV. Care must be taken to identify situations where multiple consecutive fair values, although individually immaterial, when taken together result in a change in NAV.

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