

SEC Enforcement Action Provides Guidance on Portfolio Valuation and Disclosure

June 17, 2009

The Securities and Exchange Commission (SEC) recently brought enforcement proceedings against a fund's investment adviser and distributor for overvaluing portfolio assets over an extended period of time, and later selectively disclosing to certain persons information about the overvaluations, as detailed in a release published June 8 (the SEC Release).¹ As a result of the proceedings, the adviser and distributor will pay more than \$40 million in settlements and fines. Investment company boards of directors, investment advisers, and investment company service providers should consider whether their valuation and disclosure policies contain safeguards to prevent the behavior that was the subject of this SEC action.

Background

On June 8, the SEC instituted and simultaneously settled administrative cease and desist proceedings against a Boston-based investment adviser and its affiliated distributor, related to alleged violations of certain sections of the Investment Advisers Act of 1940 (Advisers Act), the Investment Company Act of 1940 (Investment Company Act), and the Securities Exchange Act of 1934 (Exchange Act).² The SEC Release enumerates the violations in detail; they are described as follows:

Overstated Value of Fund Assets. The proceedings stemmed from the valuation practices of a single mutual fund, which invested primarily in mortgage-backed securities. According to the SEC Release, the fund overstated its net asset value (NAV) per share by as much as 17% from February 2007 until June 18, 2008. This overvaluation resulted from the fund's management team's failure to account for "various readily-available information" when making pricing recommendations to the fund's valuation committee.³ Furthermore, according to the SEC Release, the fund's management team failed to provide the fund's valuation committee with "relevant negative information about certain residential mortgage-backed securities" held by the fund.⁴

Because of the overstated NAV, redeeming shareholders received more than they should have, which diluted the holdings of the fund's remaining shareholders, and purchasers paid more than they should have.

The overstated valuations resulted in current and prospective investors receiving inaccurate performance information and the fund appearing to perform better than comparable funds, whereas its actual rank should have been "at or near the bottom of its fund category."⁵ In addition, the overvaluations resulted in the adviser receiving inflated advisory fees.

Valuation Procedures. The fund had a fundamentally sound set of valuation procedures. It was the operation of

1. In the Matter of Evergreen Inv. Mgmt. Co., LLC & Evergreen Inv. Serv., Inc Investment Company Act Release No. IC-28759, (June 8, 2009), available at <http://www.sec.gov/litigation/admin/2009/34-60059.pdf>.

2. The sections addressed in the SEC Release are Sections 206(2) and 204A of the Advisers Act, Sections 22(c), 34(b) and 17(a)(2) of the Investment Company Act and Section 15(f) of the Exchange Act.

3. See In the Matter of Evergreen, *supra* note 1 at 2.

4. *Id.*

5. *Id.*

these procedures which was faulty.⁶ Each security was initially to be valued at the market price or, for those securities for which no market price was available, at the fair value price as determined by the fund's board of trustees in accordance with the fund's valuation policies. The fund's valuation policies granted the fund's valuation committee the authority to determine the fair value of securities for which no market price was available.

The fund's valuation committee used a three-tier system to value securities with no market price. The system's first tier utilized a third-party pricing vendor; the second tier utilized one or more third-party broker-dealers; the third tier deferred to the fund's management team. However, according to the SEC Release, the fund's valuation committee often used prices from a single broker-dealer or used recommendations from the management team *instead of* available prices provided by a third-party pricing vendor. Also, according to the SEC Release, the fund's valuation committee relied on prices received from a single broker-dealer without first conducting adequate due diligence on the broker-dealer providing the valuation and without reviewing or approving its valuation methodology.⁷

Selective Disclosure of Material, Nonpublic Information. Prior to the fund's liquidation on June 18, 2008, the fund began to reprice its assets, which caused the fund's NAV per share to decline from \$9.20 on May 23, 2008 to \$7.48 on June 18, 2008. In response to the declining NAV, the fund did not supplement its prospectus, issue a press release, or otherwise disclose the ongoing repricing. Rather, the distributor gathered information about the reduced valuations from the adviser and prepared a series of talking points for use with investors or broker-dealers who inquired about the dropping share price of the fund. These talking points indicated that the repricing process was ongoing and thus, according to the SEC Release, "constituted material, nonpublic information."⁸ This selective disclosure favored certain shareholders to the detriment of others.

Violations of the Federal Securities Laws. The SEC determined that the fund's adviser had willfully operated a fraud or deceit upon its client, the fund, in violation of Section 206(2) of the Advisers Act. Furthermore, the distributor, according to the SEC Release, aided and abetted the adviser's violation of Section 206(2) by providing "substantial assistance" to the adviser through the selective disclosure of the repricing information.

According to the SEC, the adviser also violated Section 204A of the Advisers Act, which requires an investment adviser to maintain and enforce written procedures to prevent the misuse of material, nonpublic information. Similarly, the distributor violated Section 15(f) of the Exchange Act for failing to have similar written policies.

Terms of Settlement. In settlement of these violations, the adviser and distributor agreed to, among other things, (i) engage the services of an independent consultant and (ii) compensate shareholders \$33,000,000 for harm caused.

Discussion

Although noteworthy for its extreme underlying facts, the SEC Release is a useful reminder to investment company boards of directors, investment advisers, and service providers that valuation procedures may not be complete without provisions to monitor whether the valuations being used fairly reflect market values and, if they do not, whether there is an appropriate reason for the discrepancy, for example, distressed sales. It also reflects favorably on the practice of automatically comparing the price received on the sale of a fair-valued security against the most recent valuation. It also suggests that it might be advisable, when a fund holds a large block of a fair-valued security, to sell a portion of the position periodically as a means of determining whether there is a material difference between the valuation being used and market value.

Boards Should Update Valuation Procedures to Reflect FAS 157-4. Although not a central element in these proceedings, whether a security is distressed will affect the proper valuation procedures and investment company boards should consider a recent statement on this subject. The Financial Accounting Standards Board (FASB) recently adopted FAS 157-4, which is designed to further help reporting entities, including registered investment

6. To illustrate the misapplication of sound policies, an affiliated fund purchased a collateralized debt obligation for \$9.50 on May 23, 2008, while the fund simultaneously was valuing the same security for \$98.93. See *id.* at 6. In response, the fund's management team asked the selling broker-dealer whether the price resulted from a distressed transaction. Although the broker-dealer stated that the transaction was not distressed, the fund's management team reported that the sale was distressed to the fund's valuation committee and omitted the broker-dealer's statement.

7. When the Fund re-priced securities in June 2008, 15 of the 16 securities whose values were based on prices provided by this broker dealer were marked down, eight by more than 90%.

8. *Id.* at 8.

companies, determine fair value.⁹ This new guidance establishes a two-step process to help investment companies determine whether (1) markets are inactive and (2) transactions are forced or distressed. Under FAS 157-4, investment companies must first consider a list of factors to determine whether the market for a particular asset or liability has significantly decreased in the volume and level of activity for the asset or liability (or similar assets or liabilities) compared with the normal market activity. If an investment company determines that a market is inactive, then it should further examine the quoted or transacted price of an asset or liability to determine whether it is derived from a disorderly transaction, based on the “weight of the evidence.”

If, under the circumstances, an investment company determines that the price quote of a specific asset is the result of an inactive market *and* a disorderly transaction, then the investment company should make adjustments to the quoted price to arrive at a fair valuation. An investment company should only use its fair valuation procedures after undergoing this extensive analysis. Furthermore, this analytical process itself should be documented and recorded by the investment company.

Universal, Simultaneous Disclosure, If Any. Investment companies and investment advisers cannot favor one shareholder or advisory client at the expense of another. An investment company or adviser cannot selectively disclose material, nonpublic information to shareholders. Any disclosure should be effected immediately, simultaneously, and universally by way of a prospectus supplement, press release, or other means.

Further Questions

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9. See Determining Fair Value When the Volume Level of Activity for the Asset of Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, FASB Staff Position No. FAS 157-4 (Apr. 9, 2009).