



Financial Fraud Law Report

AN A.S. PRATT & SONS PUBLICATION

FEBRUARY 2013

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POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. ISSN 1936-5586

SEC Focuses on Fair Valuation in Recent Enforcement Cases

JANE A. KANTER AND ROBERT G. ZACK

The authors analyze recent cases regarding valuation deficiencies that highlight the priority put on asset valuation investigations by the Securities and Exchange Commission's Enforcement Division's Asset Management Unit and that provide insight into the SEC's views as to the policies, procedures and practices investment company boards and investment advisers should follow in (i) adopting fair valuation policies and procedures and (ii) fair valuing portfolio securities when and as required by Section 2(a)(41) of the Investment Company Act of 1940, as amended.

The U.S. Securities and Exchange Commission (“SEC”) issued an order commencing an administrative proceeding against the former members of the boards of directors (“Boards”) of five registered investment companies on December 10, 2012, charging them with alleged violations of the Boards’ responsibilities to fair value portfolio securities for which market quotations were not readily available (“RMK Board Proceeding”).¹ This proceeding, which is currently pending, follows the recent settlement of another portfolio securities valuation case involving an internally-managed business development company (“BDC”),² and the commencement of civil litigation against a hedge fund firm and its principals over, among other things, portfolio valuation issues.³

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These and other recent cases regarding valuation deficiencies highlight the priority put on asset valuation investigations by the Enforcement Division's Asset Management Unit⁴ and provide insight into the SEC's views as to the policies, procedures and practices investment company boards and investment advisers should follow in (i) adopting fair valuation policies and procedures and (ii) fair valuing portfolio securities when and as required by Section 2(a)(41) of the Investment Company Act of 1940, as amended ("1940 Act"). The views of the SEC regarding such matters are also relevant to advisers to private funds and managed accounts where the adviser has responsibility for valuations and those valuations are used in setting the price of interests or in determining fees or presenting performance.

The RMK Board Proceeding is still pending, so it is premature to draw conclusions about the views of the SEC expressed in the complaint against the former members of the Boards ("Complaint"). However, fund boards, advisers and their counsel should review the Complaint and the KCAP Proceeding and consider the developments in the RMK Board Proceeding as they consider their own practices, policies and procedures regarding fair valuation.

SUMMARY OF ALLEGATIONS IN THE COMPLAINT

In its Complaint against the former members of the RMK Funds' Boards, the SEC alleges that in 2007, each of the RMK Funds⁵ held a majority of their respective assets in below-investment grade debt securities for which market quotations were not readily available. As a result, those securities were required to be fair valued as determined in good faith by the respective Boards in conformity with Section 2(a)(41)(B)(ii) of the 1940 Act. The Complaint further notes that a "board may appoint persons to assist them in determination of such [fair values], and to make the actual calculations pursuant to the board's direction. The board must also, consistent with this responsibility, continuously review the appropriateness of the method used in valuing each issue of security (sic) in the company's portfolio."

The Complaint alleges that the Boards failed in that responsibility in several ways, including by delegating their responsibility to determine the value of securities requiring fair valuation ("securities") to a valuation committee of the investment adviser without providing "any meaningful substan-

tive guidance” on how those fair valuation determinations should be made. In addition, the Complaint alleges that the Boards did not make any meaningful effort to learn how fair values were actually determined and received, at best, only limited explanation as to the information considered in making fair valuation determinations and almost no information as to why particular fair values were made. The Complaint notes that these failures were particularly “egregious” in view of the fact that the securities made up more than 50 percent of each fund’s net asset value (“NAV”).

According to the Complaint, as a result of these failures, NAVs of the RMK Funds were materially misstated for at least a five-month period in 2007 (i.e., between January 2007 and August 2007) (“Relevant Period”), with the result that the prices at which the open-end funds were sold, redeemed and repurchased were inaccurate.

THE BOARDS’ VALUATION PROCEDURES

The Complaint is critical of the valuation policies and procedures adopted by the Boards, which the SEC describes as containing a list of 3 general factors and 10 specific factors to be considered in making fair value determinations. According to the SEC, that was insufficient; they noted that the general and specific factors were “copied nearly verbatim” from ASR 118⁶ but provided “no meaningful methodology or specific direction on *how* to make fair value determinations for specific portfolio assets or classes of assets.”

The Complaint further criticizes the fair valuation policies and procedures adopted by the Boards for several specific issues, including that; (i) they provided no guidance as to how the listed factors should be interpreted and applied (e.g., whether some factors should be weighed more or less heavily than other factors or what specific information qualified as “fundamental analytical data relating to the investments” or “forces that influence the market in which these securities are bought and sold” for particular types of securities); (ii) they did not specify what valuation methodology should be employed for each type of security, or, if there was no specified methodology, how to evaluate whether or not a particular methodology was appropriate; and (iii) they did not have a mechanism or process for identifying and reviewing “stale-priced” securities whose values had not changed over a long period of time. The Complaint also

notes that the Boards did not provide “other guidance” on how to determine fair value beyond what was stated in the valuation procedures.

ASR 118 does not provide a detailed explanation of the general and specific factors described in the Release. Rather, the Release suggests that the application of judgment in applying those general and specific factors is a significant part of the fair valuation process.⁷ In this regard, ASR 118 states that, in determining the fair value of securities, all indications of value available should be used.⁸ ASR 118 states that “[n]o single standard for determining ‘fair value...in good faith’ can be laid down, since fair value depends upon the circumstances of each individual case.”⁹ Further, ASR 118 states that “[t]he information so considered together with, to the extent practicable, judgment factors considered by the board of directors in reaching its decision should be documented” along with the supporting data relied upon.

Without reviewing the actual valuation policies and procedures adopted by the Boards, it is not possible to assess how detailed those policies and procedures were in providing specific methodologies to be used by the valuation committee in forming fair valuation judgments. In addition, it is unclear what level of detail the SEC expects valuation policies and procedures to contain in the absence of more current guidance from the SEC or its staff in this area. In remarks to the ALI CLE Conference on December 6, 2012, Norm Champ, Director of the SEC’s Division of Investment Management, acknowledged that “there is a need to provide additional guidance on valuation of securities held by registered investment companies...because much has changed since the Commission last issued guidance regarding valuation.”¹⁰

DELEGATION OF AUTHORITY TO THE VALUATION COMMITTEE

The SEC acknowledges in the Complaint that fund boards may delegate the day-to-day responsibility for valuation of portfolio securities to a valuation committee. That practice has been recognized by the SEC and its staff for a number of years, both as the subject of interpretive guidance in ASR 118,¹¹ no-action relief¹² as well as commentary in 1999 SEC Staff Valuation Guidance to the fund industry.¹³ In particular, the 1999 SEC Staff Valuation Guidance acknowledges concerns by the industry that mutual fund boards are ill-equipped to fair value securities and the obligations placed on such boards

are burdensome. In response to this concern, the 1999 SEC Staff Valuation Guidance states that “[m]utual funds fulfill their obligations by reviewing and approving pricing methodologies, which may be formulated by the board, but more typically are recommended and applied by fund management.”

IMPLEMENTATION OF THE FAIR VALUATION PROCESS

The Complaint alleges that, in actual practice, the investment adviser’s fund accounting department was assigned the responsibility for fair valuation of securities on a daily basis (to the extent required by Section 2(a)(41) of the 1940 Act), but did not use “reasonable analytical methods” to arrive at fair values, such as pricing models or an analysis of future cash flows a particular security could generate. The Complaint notes the initial fair value of a security typically was set at its purchase price (i.e., cost) and, thereafter, was left unchanged unless a sale or price confirmation indicated more than a five-percent variance from the previously assigned fair value.

The Complaint states that price confirmations of the fair valuations of the securities were sought only on a monthly basis on a randomly-selected group of securities, except in connection with annual audits, when the price confirmation of every security was sought. The Complaint states that the “price confirmations were essentially opinions on price from broker-dealers, rather than bids or firm quotes.”¹⁴

According to the Complaint, the price confirmations almost always contained disclaimers making clear that the price confirmations provided were not an offer to buy the securities at the stated price. In addition, the Complaint notes that the monthly confirmations were obtained several weeks after the respective month-ends.

The Complaint states that “although these monthly price confirmations could not suffice as the primary valuation method” for daily calculation of the RMK Funds’ NAVs, the month-end price confirmations were allegedly regularly relied on by the fund accounting department when making daily fair valuation determinations. The Complaint further asserts that if a monthly confirmation showed a variance of more than five percent from the current price of any securities, the fund accounting department would consult with the portfolio manager to price those securities.

The Complaint is also critical of the process employed by the investment adviser and its fund accounting department regarding price overrides, alleging that overrides of the monthly price confirmations were not documented, reported or explained to the valuation committee for its review, as required under the valuation procedures. The Complaint alleges that, because the valuation committee and fund accounting department interpreted this reporting requirement as applying only to quotations obtained from broker-dealers, the valuation committee did not receive notice or explanation when the fund accounting department “chose to ignore the price confirmations.” According to the Complaint, this practice allowed the portfolio manager to override the monthly price confirmations and to “arbitrarily set values without a reasonable basis and [the portfolio manager] did so in a way that postponed the degree of decline in the NAVs of the [RMK] Funds which should have occurred during the Relevant Period.”

The Complaint alleges that, during most of the Relevant Period, the valuation committee met monthly, but it received “insufficient information” to enable it to do its job properly in evaluating the fair valuations assigned to securities by the fund accounting department. In this regard, the Complaint states that the valuation committee did not perform “any additional tests to validate the fair values of portfolio securities that had not been sold or confirmed from a broker-dealer” and, on a monthly basis, sought price confirmations from broker-dealers for as few as 10 percent of the fair valued securities.

ALLEGATIONS OF THE BOARDS’ FAILURES TO OVERSEE FAIR VALUATIONS

The remainder of the Complaint details the alleged failures of the Boards in overseeing the fair valuation process, particularly in requesting, reviewing and evaluating reports from the valuation committee and the investment adviser as to the fair valuation decisions made by them. The details provided in the Complaint regarding the alleged failures of the Boards to sufficiently oversee the valuation process used by the valuation committee are the real heart of the Complaint.

The Complaint alleges that, while the Boards received information at their quarterly Board meetings about fair valued securities, the information

provided to them did not contain sufficient information for the Board members to understand what methodology was being used by the fund accounting department to fair value securities. According to the Complaint, the reports of fair valued securities provided to the Boards at their quarterly meetings did not provide any means for the Boards to determine (i) the type of security that was fair valued, (ii) the basis for any particular fair value assigned to a security, or (iii) whether that price had changed from the prior quarterly report. In addition, the Complaint alleges that while the frequency of the Boards' review of fair valuations of securities increased after the Boards were contacted by the SEC staff in July 2007 about the staff's valuation concerns, the Boards "still never asked specific questions" of management about how assets were being valued and how those values were tested.

The Complaint then details the alleged inadequacy of the information provided to the Boards for their consideration with respect to fair valuation determinations. The Complaint states that the Boards received three documents, on a quarterly basis, relating to fair valuation of securities and describes one of those documents (*i.e.*, the Report from the Joint Valuation Committee) as "largely uninformative" since it did not provide (i) any information as to how fair values were determined or (ii) any details on how fair valued securities were "randomly confirmed with third parties." The Complaint alleges that the other two documents (*i.e.*, the Fair Valuation Form and the Basis/Source/Method for Determining Price Used) each contained boilerplate phraseology and wording that the Board members did not understand, including how the internal matrix pricing (used to value the securities) operated.

The Complaint states that requirements for reports to the Boards under the valuation policies and procedures were also not followed. For example, the Complaint states that the explanatory notes for the fair valuations assigned to securities, required by the valuation policies and procedures, were not requested by or presented to the Boards.

The Complaint further alleges that, although price confirmations played a significant role in the fair valuation process, the Boards never established guidelines regarding their use, including (i) the frequency of requests for price confirmations, (ii) how broker-dealers providing the confirmations should be selected, or (iii) how to identify securities for which no confirmations had

been received. The Complaint also alleges that the Boards failed to require any review to identify “stale-priced” securities.

ALLEGED VIOLATIONS BY THE MEMBERS OF THE BOARDS

The Complaint does not allege fraudulent conduct by the Boards nor a breach of fiduciary duty under the 1940 Act. However, the Complaint alleges four violations of federal securities laws arising from the alleged conduct described in the Complaint:

1. The Boards caused the open-end RMK Funds to violate Rule 22c-1 under the 1940 Act whereby funds issuing redeemable securities (and persons authorized to sell them) must sell, redeem or repurchase those securities at the current net asset value;
2. The Boards caused the RMK Funds to violate Rule 38a-1 under the 1940 Act, which requires registered management investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of federal securities laws;
3. The Boards caused the RMK Funds to violate Rule 30a-3(a) under the 1940 Act, which requires registered management investment companies to maintain internal control over financial reporting; and
4. The Boards willfully caused one of the RMK Funds to make a false or misleading statement of a material fact in its SEC registration statement.

The independent directors named in the Complaint have issued a press release stating that they intend to contest the case vigorously. They criticized the Complaint as a “misguided attempt to retroactively regulate by enforcement in an area in which the SEC has been unwilling or unable to provide meaningful guidance through the normal regulatory process.” The directors pointed out that, in the 2011 enforcement action against the investment adviser, the SEC determined that the independent directors had been defrauded by fund management, and that, in 2007, the independent auditors advised the Boards “that the funds’ valuation procedures were reasonable and appropriate, and that the process was working properly and producing correct fair valuations.”¹⁵

THE KCAP PROCEEDING

In the order (“Order”) settling the complaint in the KCAP Proceeding against KCAP Financial, Inc. (“KCAP”), an internally-managed BDC,¹⁶ and certain of its principal executive officers, the SEC alleged that KCAP materially overstated the value of its portfolio of debt securities and collateralized loan obligations (“CLOs”) in its financial statements from the end of 2008 to the middle of 2009, resulting in violations of Section 13(a) of the Exchange Act and certain of the rules thereunder that call for registrants to file annual, current and quarterly reports, and to keep accurate books and records.

In brief, the SEC alleged that KCAP (i) did not account for market-based activity in deriving fair valuations of its debt securities and certain of its CLO holdings, and (ii) failed to disclose that it had valued its two largest CLO investments at cost and, thus, did not record and report the fair value of its assets in accordance with generally accepted accounting principles (“GAAP”). The SEC Press Release announcing the settlement noted that it was the first enforcement action against a public company alleging failure to comply with the requirements of FAS 157 (redesignated as ASC 820 in September 2009), an accounting standard issued by the Financial Accounting Standards Board to define “fair value” and establish a framework for its measurement and reporting in financial statements.

The Order states that FAS 157 defines “fair value” for a security as an “exit price” which reflects what would be received in the sale of an asset in an orderly transaction between market participants at the measurement date. The Order describes that process as a market-based measurement, not an “entity-specific” measurement, and should be based on the assumptions that market participants would use in pricing the asset. The crux of the KCAP Proceeding was that its public financial statements were misstated because, during the tumultuous market of late 2008 and early 2009, KCAP used valuation methodologies that were based on cost derived from an analysis of enterprise value, and that the principals of KCAP caused it to fail to comply with GAAP because they did not look at available transactional data until they restated the company’s financials in May 2010.

ALLEGED MATERIAL MISSTATEMENTS OF VALUE OF DEBT SECURITIES

KCAP was required to use valuation methodologies consistent with FAS 157, starting in 2008. For part of that year, KCAP classified some of its holdings of debt securities as liquid and relied on prices provided by pricing services hired by KCAP. For debt securities classified as illiquid, KCAP used a fair valuation methodology based on “enterprise value,” which basically looked to an enterprise value to determine whether KCAP would receive the full repayment of its loan in the event of the borrower’s default or liquidation, rather than using trade data from market transactions, even though KCAP’s officers responsible for valuations were aware of such market activity and of actual price quotes for several of the debt securities KCAP held.¹⁷ If the issuer’s enterprise value was greater than its total outstanding debt under that methodology, the security was valued at cost. If the enterprise value was less than the outstanding debt, KCAP would adjust the value below the cost. However, that methodology did not include a determination of an “exit price” if KCAP were to sell the security. According to the SEC, that approach caused KCAP to overvalue virtually all of its debt securities in the last quarter of 2008.

Ultimately, when KCAP restated its financials in May 2010, it applied an income-based valuation methodology that involved projected cash flows of particular securities, discounting payments to present value. According to the Order, this approach resulted in a restatement of a majority of the debt securities.

ALLEGED MISSTATEMENTS OF VALUE OF CLOS

KCAP used different methodologies to fair value its CLOs, using models that took into account current market conditions for some of the CLOs, but using valuations based on cost for its two largest CLO positions. The SEC alleged that the financial statements reported that the latter two positions had been valued using market-based inputs and thus were materially misleading. When it restated its financial reports in May 2010, KCAP acknowledged that it had material weaknesses in its internal controls for valuing its portfolio

assets, because its prior valuation procedures did not adequately take into account market inputs and other data.¹⁸ In settling the KCAP Proceeding, the three principals paid monetary penalties, and they and KCAP agreed to cease and desist from future violations of Section 13(a) of the Exchange Act, and the applicable rules thereunder.¹⁹

CONCLUSIONS

The RMK Board Proceeding and the KCAP Proceeding are just two of a series of settled and pending actions arising from the continuing focus of the SEC and its staff on valuation issues in the asset management industry. One clear message is that registered investment companies and their boards, as well as advisers to registered investment companies, private funds and managed accounts who are involved in the valuation of portfolio holdings, should focus on the need for periodic review of their valuation policies and procedures to assure that they are appropriate (in light of the securities being valued) and take into account applicable accounting and regulatory requirements as well as the fiduciary duties of advisers and fund boards.

The KCAP settlement is instructive as to (i) the SEC's interest in possibly looking outside the traditional literature (e.g., ASR 113 and 118) for the standards applicable to financial reporting as to results of fair valuation decisions made for investment companies, and (ii) the importance of assuring in the fair valuation process that market-based inputs are considered in deriving an "exit price" for portfolio securities.

With respect to the RMK Board Proceeding, it should be emphasized that it is an ongoing matter that the former members of the Boards have indicated they will vigorously challenge. No conclusions can be drawn about the likelihood of success by the SEC as to allegations raised in the Complaint or what the possible terms of any settlement might be if that avenue is ultimately pursued.

One implication of the SEC's Complaint in the RMK Board Proceeding is that where valuation policies and procedures mandate that (a) certain types of reports be prepared and provided to the valuation committee and/or the board and (b) certain specific policies, procedures and processes be followed, a fund's board should take all steps deemed necessary and appropriate to as-

sure that (i) required reports are prepared and provided in sufficient detail to enable the fund's board to oversee the fair valuation process, (ii) if needed, steps are taken to revise a fund's valuation policies and procedures to reflect the actual practices being followed in making fair valuation determinations, and (iii) the valuation policies and procedures are fully implemented as written.²⁰ In addition, the Complaint suggests that there is a need for boards to (a) take an active role in overseeing the valuation process used by funds, especially if day-to-day responsibility for valuation decisions has been delegated to others, and (b) seek greater specificity as to the fair valuation methodologies and processes used for all securities in a fund's portfolio. The industry is very interested in receiving new guidance from the SEC and/or its staff regarding valuation policies and procedures, including how those valuation responsibilities should be carried out. We are hopeful that this initiative will give the industry an opportunity to engage in discussions with the SEC staff regarding the practicalities of implementing various valuation policies and procedures.

NOTES

¹ *In the Matter of J. Kenneth Alderman, et al.*, Investment Company Act Release No. 30300 (Dec. 10, 2012); Admin. Proc. File No. 3-15127. The five funds are referred to herein as the "RMK Funds." In 2011 the SEC settled a related action against the investment adviser, the distributor and a portfolio manager of the five funds on the same asset valuation issues. *In the Matter of Morgan Asset Management, Inc., et al.*, Investment Company Act Release No. 29704 (June 22, 2011).

² *In the Matter of KCAP Financial, Inc., et al.*, Securities Exchange Act of 1934 Release No. 68307 (Nov. 28, 2012); Admin. Proc. File No. 3-15109 (KCAP Proceeding).

³ *SEC v. Yorkville Advisors, LLC, et al.*, Case No. 12 Civ. 7728 (S.D.N.Y., filed Oct. 17, 2012).

⁴ Press Release, U.S. Sec & Exch. Comm'n, SEC Charges Eight Mutual Fund Directors for Failure to Properly Oversee Asset Valuation (Dec. 10, 2012), available at <http://www.sec.gov/news/press/2012/2012-259.htm>.

⁵ One of the RMK Funds was an open-end fund with three series, and the other four were closed-end funds. In the Complaint, the SEC states that "[t]he closed-end funds calculated and published daily NAVs, although these were not the

basis of transactions in their shares.” *Compare*, December 1999 Letter to the ICI Regarding Valuation Issues, Div. of Invest. Mgmt., U.S. Sec & Exch. Comm’n, n.13 (Dec. 8, 1999) [hereinafter 1999 SEC Staff Valuation Guidance] (stating that “[t]he failure [of closed-end funds] to report accurate NAVs may result in the market being misled and investors buying and selling fund shares at market prices that are based, in part, on inaccurate NAVs.”).

⁶ Accounting Series Release No. 118, “Accounting for Investment Securities by Registered Investment Companies,” Investment Company Act Release No. 6295 (Dec. 23, 1970) (ASR 118 or Release).

⁷ *Id.* Indeed, the Release states that “[t]he standards set forth below should be considered as guidelines, one or more of which may be appropriate in the circumstances of a particular case. These standards should be followed, and a company’s stated valuation policies should be consistent with them.”

⁸ We assume that this means all relevant and reliable sources of information should be used in the fair valuation process.

⁹ *Supra* n.6. The Release, along with ASR 113 (Accounting Series Release 113, Investment Company Act Release No. 5847 (Oct. 21, 1969) on restricted securities) comprise the SEC’s official interpretive guidance on accounting practices for financial statement purposes and valuation of securities for calculating NAV.

¹⁰ Norm Champ, Dir., U.S. Sec & Exch. Comm’n, Remarks to the ALI CLE 2012 Conference on Investment Adviser Regulation: Legal and Compliance Forum on Institutional Advisory Services (Dec. 6, 2012) (transcript available at <http://www.sec.gov/news/speech/2012/spch120612nc.htm>).

¹¹ *Id.* ASR 118 states that “To the extent considered necessary, the board may appoint persons to assist them in the determination of such [fair] value, and to make the actual calculations pursuant to the board’s direction.”

¹² *See* Paul Revere Investors Inc., File No. 811-2197 (avail. Aug. 18, 1972), in which a closed-end fund’s board was granted relief to appoint a securities valuation committee to value restricted securities held by the fund between meetings of the entire board, under guidelines set by the board. In granting the no-action relief, the SEC staff added the proviso that the valuation committee must advise the board at any time it believes that the methods established for valuing restricted securities are “erroneous” so that the board can determine whether to modify such methods. Interestingly, the SEC staff added relief that had not been requested, by allowing the procedures to be used for unrestricted securities for which no market quotations were available.

¹³ *Supra* n.5. In the 1999 SEC Staff Valuation Guidance, the SEC staff states that “[m]utual funds also may use a number of other techniques to minimize the burdens of fair value pricing on their directors. For example, a number of funds delegate certain responsibilities for fair value pricing decisions to a valuation committee. Such committees generally assist the board in developing methodologies by which fair values are to be calculated, and implement the board-approved methodologies on a day-to-day basis or as frequently as necessary.”

¹⁴ It is unclear what inference to draw from the reference to that practice in the Complaint and, in particular, whether the SEC intends to criticize the common industry practice of using so-called “accommodation” prices for over-the-counter or non-exchange traded securities for which there are no pricing service price quotations or no reported transactions on a given day. From both a pragmatic standpoint and to address conflicts of interest that might arise from the need in some instances to consult with portfolio management personnel as part of the fair valuation process, many fund groups prefer to use independent price quotations provided by at least two market makers in such securities rather than estimating values using fair valuation procedures that employ only internal inputs. This valuation process was recognized by the SEC staff in Guide 50 in the Guidelines for Form N-1A, initially published by the SEC in Investment Company Act Release No. 13436 (Aug. 12, 1983).

¹⁵ “Statement on Behalf of the Former Independent Directors of the Regions Morgan Keegan Funds,” (Dec. 10, 2012), *available at* http://www.mfdf.org/images/uploads/about_files/RMKDirectorStatement.pdf.

¹⁶ A BDC is a type of closed-end investment company designed to facilitate the raising of capital by small and mid-sized U.S. businesses. BDCs are exempt from some of the requirements of the 1940 Act and rules thereunder but are subject to provisions that apply to closed-end funds, such as Section 2(a)(41)(B)(ii), requiring the board of directors to determine the fair value of the BDC’s assets in good faith when market quotations are not readily available. Interestingly, the Order applies the fair value standards of FAS 157 to the analysis of the alleged violations of the financial reporting requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), by KCAP, but does not refer to the application of ASR 113 or 118 (both of which apply to “registered investment companies”) in reviewing the portfolio holdings valuation decisions made by KCAP that were the subject of the enforcement action by the SEC.

¹⁷ The Order states that the officers responsible for the valuations believed that, as a result of late-2008 market turmoil, reported transaction data did not

represent fair value.

¹⁸ The SEC also found two of the KCAP officers to have violated Rule 13a-4 under the Exchange Act, which requires principal executive officers and principal financial officers to include with periodic reports filed with the SEC a certification that the officers have reviewed the report and have designed or caused to be designed internal controls with respect to financial reporting that provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. In particular, the SEC stated that “[i]n light of the errors resulting in the restatement and KCAP’s internal controls failures, these certifications were false.”

¹⁹ The penalties are relatively less onerous than those levied against two directors of another BDC in an earlier case that included, among other allegations, the use of improper valuation methods for various portfolio holdings (reliance on values of restricted securities obtained from the “pink sheets,” which the SEC asserted ignored the underlying financial condition of the investee issuers and was in violation of applicable accounting literature, including ASR 113). *In the Matter of William P. Hartl and Eric P. Lipman*, Investment Company Act Release No. 19840 (Nov. 8, 1993). Both directors received “cease and desist” sanctions and permanent bars from association with any broker, dealer, municipal securities dealer, investment adviser or investment company.

²⁰ Compare the SEC’s findings of fact and violations of law in the order settling the case against the board of directors of the Heartland Funds with the allegations in the Complaint. *In the Matter of Heartland Advisors, Inc., William J. Nasgovitz, et al.*, Investment Company Act Release No. 28136 (Jan. 25, 2008). In the *Heartland* matter, the SEC found that the directors of the Heartland Funds “did not adequately discharge their responsibility to participate meaningfully in the valuation of the Funds” and “failed to take adequate steps to follow up on their requests for information” from Heartland Advisors, when they were on notice of the problems with the prices of the securities of the Heartland Funds, in order to assure that those securities were priced at fair value. Further, the board of directors in the *Heartland* matter committed violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, as amended, by permitting and not rectifying the haircut Heartland Advisors applied to the securities held by the Heartland Funds, which they knew or should have known resulted in prices that did not represent the fair values of the bonds affected. *See also, In the Matter of Jon D. Hammes, et al.*, Investment Company Act of 1940 Release No. 26290 (Dec. 11, 2003), and *In the Matter of Parnassus Investments*, Initial Decision Release No 131, Admin.

Proceeding File No. 3-9317 (Sep. 3, 1998), in which the Administrative Law Judge found that the board of trustees of the Parnassus Fund violated Rule 22c-1 of the 1940 Act because they did not follow the requirements of ASR 113 and ASR 118 (by ignoring or failing to give adequate consideration to the general and specific factors in ASR 118) when they made a fair valuation decision with respect to a restricted security that did not employ a current sale methodology, causing the fund's NAV to be misstated.