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Morgan Keegan Case Spurs Valuation Soul Searching

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The SEC's case against eight former Morgan Keegan directors over alleged valuation shortcomings has exacerbated firms' fears about the adequacy of their own valuation processes.

This is largely because the SEC's expectations in this area have been notoriously murky, with no formal guidance or regulations.

As a result, numerous firms in the weeks and months following the December enforcement action have sought an external assessment or reassessment of their valuation policies and procedures, according to executives at compliance consulting firms.

The SEC and the Morgan Keegan directors reached a settlement "on all major terms," according to a Thursday joint motion by the parties to stay the case that was first reported in *Ignites's* sister publication *BoardIQ*.

There has been "considerable interest" from existing and prospective clients regarding valuation in the wake of the Morgan Keegan case, says Ralph Mittl, director at consulting firm **Promontory Financial Group**.

Some clients refer to the Morgan Keegan case specifically, while others cite speeches by SEC officials that highlight valuation as an exam focus. The increased interest in valuation is a culmination of the two, he says.

Fund firms want to know if the methodology they are using for valuation is appropriate and whether they have the right people within the company determining fair values. Firms also are taking a closer look at their processes for backtesting fair values, Mittl says.

The SEC alleged in the recent case that while directors bear responsibility for determining securities' fair value, the Morgan Keegan directors delegated those duties to the advisor without providing "meaningful substantive guidance" on calculating the valuations.

The directors did not continuously review the appropriateness of the fair valuation methodology or make a significant effort to understand the valuation methods, the SEC alleged, among other claims.

Morgan Keegan reached a \$200 million settlement with regulators in 2011 over valuation issues.

ACA Compliance Group typically does not get requests to focus solely on valuation, but it has gotten them following the Morgan Keegan case, says Christopher Kemp, a principal consultant at the firm.

Fund boards have stepped up their questioning of advisors when it comes to valuation, he says. They want more information about how written policies and procedures translate into actions.

“They’re asking [advisors] more detailed questions about the whole process,” says Kemp.

Some boards have asked advisors to give them a presentation on valuation in recent board meetings so the directors can fully understand how the advisor is valuing securities in accordance with policies and procedures, says Christopher Tafone, senior associate at Paul Hastings.

Janaya Moscony, founder of SEC Compliance Consultants, says firms are more concerned about valuation as a result of the Morgan Keegan case, but also worried more generally about what board members’ responsibilities are.

External assessments of valuation processes have led some advisors to change their policies to make sure they are an accurate reflection of the daily processes, ACA Compliance’s Kemp says.

Indeed, given that fund boards and advisors typically work together on determining and implementing valuation policies and procedures, advisors appear to be just as concerned about the SEC’s enforcement action as directors.

“This [case] is not just a warning shot to investment companies [funds] and boards of directors,” says Mittl. “It’s also a warning shot to investment advisors that they need to be paying attention to their valuation methodologies and procedures.”

Mittl says one firm with which Promontory worked allowed the portfolio manager to be part of the fair valuation determination. That has now changed.

While traders and portfolio managers should be able to express their opinion on whether a valuation is accurate, they should not be making the determination, he says.

The SEC’s 2011 settlement with Morgan Keegan found that a former portfolio manager of the funds at issue, James Kelsoe, instructed the firm’s fund accounting department to make price adjustments to the fair values of certain securities.

The adjustments ignored lower values for the same securities that were provided by outside broker-dealers as part of the pricing process.

Mark Hepsworth, president of pricing and reference data at Interactive Data, says that from his perspective the SEC’s recent case against the Morgan Keegan directors has only accelerated a trend that was already under way.

The number of due diligence meetings with fund firms and presentations to boards about Interactive Data’s valuation processes increased by 26% in 2012, as compared to 2011, says Hepsworth.

The industry also has had a positive reaction to one of Interactive Data’s latest products, Vantage, that seeks to give firms more of a window into how valuations are reached, he says.