

Looking Ahead: Challenge and Change in the
Mutual Fund Industry*

2006



*connectedthinking

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The past few years have been eventful for the U.S. mutual fund industry. Yet, amid the revelations about late trading and market-timing abuses and criticisms about other business practices, the industry's foundation has been strengthened to provide a more robust platform for the future.

PricewaterhouseCoopers expects the industry's progress to continue in 2006 through the efforts of fund managers and boards of directors. Much of the focus of this work will continue to be on the industry's fundamentals – ensuring that both philosophies and actions are aligned with the interests of fund shareholders.

2005 in Review

In 2005, there were many storylines within the U.S. mutual fund industry. Fund management and boards sought ways – through changes in governance mechanisms and business practices – to better serve fund shareholders. Fund management enhanced policies and procedures and worked with service providers to monitor and enforce compliance with applicable laws and regulations. Meanwhile, fund chief compliance officers (CCOs) led important work in assessing the effectiveness of their funds' and service providers' implementation of compliance policies and procedures. At the end of the year, many CCOs were in the process of developing the framework for their first-ever annual compliance report, due to fund directors in 2006.

The pace of Securities and Exchange Commission (SEC) proposed rulemaking slowed noticeably in 2005, reflecting a need for the industry and its regulators to implement and take stock of the rules adopted in 2003-2004. Turnover among SEC commissioners (including the chairman) and the departure of the director of the SEC's Division of Investment Management also may have been factors. Nevertheless, a rule aimed at deterring market timing (enabling fund boards to authorize the imposition of a fee of up to 2% of redemption amounts and requiring financial intermediaries to provide certain shareholder identity and transaction information when requested by a fund) was implemented – with far-reaching operational implications.

Publicly, the major regulatory controversy in 2005 centered around the SEC's intent to implement new regulations mandating that boards of directors be composed of a minimum of 75% independent directors and be led by independent board chairpersons. Those regulations were twice challenged in court by the U.S. Chamber of Commerce and remain in abeyance pending the court's decision on whether they were enacted in accordance with established procedures.

Distribution and sales activities also received attention as fund organizations and the brokerage industry took fresh looks at revenue sharing, fund promotion and sales load breakpoint pricing practices. The SEC and firms settled significant administrative proceedings arising out of alleged misconduct in these areas.

The SEC is on course to continue strengthening the role of fund directors and is seeking to work with CCOs and others to ensure that regulatory actions can be effectively implemented to protect mutual fund investors, manage conflicts of interest and provide more relevant disclosures. Some observers believe that the regulatory pendulum may swing back toward a more collaborative approach between the SEC and fund management and directors, softening the climate that arose after the abuses came to light. Others are more cautious, noting Christopher Cox's remarks upon being sworn in as SEC Chairman in August 2005. At that time, Mr. Cox reminded all that the SEC serves *investors* and its relationships with businesses are stronger when those businesses are investor-friendly.

Looking Ahead – at Four Unabated Business Challenges

The industry's value proposition – readily accessible, professional money management services and portfolio diversification at a reasonable cost – continues to hold wide appeal. Yet, going forward, a number of forces may influence it and the industry's business model and, understandably, those forces are being closely monitored. In many respects, the fund industry's responses to them will shape the industry over the next several years. These forces are discussed below.

Competition

The industry is confronting increasing competition from other financial services sectors and growing investor awareness of attractive alternative investment vehicles; e.g., separately-managed accounts, hedge funds, exchange-traded funds, real estate investment trusts, etc.

There has been increased dialogue between fund management and directors about the relative position of their fund group(s) in the context of the mutual fund industry as well as the overall investment products marketplace – in effect, assessing the sufficiency of, and potential competitive threats to investors' ongoing interest in, current fund offerings.

This discussion has helped fund organizations focus on gaps in fund offerings, given desired and available distribution outlets and advisory competencies; redundant funds; unexpected divergences between the profile of their current and targeted shareholders (often seen in asset disparities among classes of shares among funds); potential misallocation of internal or external resources supporting the funds; and areas of potential business conflict (allowing risk mitigation measures to be put in place before unintended consequences arise).

Investment Performance

Mutual fund investors are becoming more knowledgeable about investment performance, receiving information through the Internet, fund rating services, fund communications, financial advisors, retirement plan advisories, etc.

Publicity about hedge funds has made more fund shareholders aware of the differences between mutual funds and other investment vehicles – among them, concepts of *relative* and *absolute* investment performance. As investors' knowledge increases, so do their expectations.

Some ask whether these investment objectives will continue to sharply define the mutual funds and hedge funds sectors. Recent reports identify planned acquisitions or mergers between managers in these sectors – which might lead to some degree of product integration. And there are recent examples of new mutual funds with investment objectives that include absolute performance. Others believe that mutual funds primarily serve those seeking relatively more investment return predictability, and should serve that constituency.

The considerations are at least complex in nature, if not as many in number: expected investment horizon of fund shareholders; shareholder and prospective investor demographics; adviser competencies; tolerance of advisers and fund shareholders for investment return volatility; regulatory limitations; fit with other product strategies; fee structures; potential conflicts of interest; liquidity needs; risk of asset disintermediation, etc. Ultimate determinations can be expected to vary substantially among fund families or their sponsors.

In 2006, a key point in this regard for all fund organizations (and directors) is a dialogue around *investment performance* and extending the traditional boundaries of review to incorporate a fuller picture of how their funds meet or intend to meet investors' changing and increasing expectations for relative and absolute investment performance.

Distribution

In its simplest form, fund businesses grow when their funds generate above average to superior investment returns over time, fee structures are competitive, effective distribution channels exist and financial intermediaries/shareholders are provided high-quality services.

Fund management and directors increasingly are centered on these interdependencies and face difficult questions about how best to serve fund shareholders while mindful of the importance of sustaining the vitality of their sponsoring fund organizations. Some observers note that fund management strategies using additional compensation for financial intermediaries aimed solely at driving increased distribution – without consideration of other factors influencing purchasing decisions – may have less impact than generally believed in increasing sales of funds.

What lies ahead? Not surprisingly, the full picture is not yet in view. Possible components of change may be emerging, including:

- Creating a “unified fee investment company” or employing variations of such which would establish a single fee to cover all fund operating expenses – investment advisory, distribution and other expenses. Proponents cite several advantages: A single fee more easily compared with others and understood by shareholders; greater flexibility for the investment adviser to pay for distribution whenever it believes it will benefit the funds (and its business); and more straightforward assessments by fund directors about fee levels;
- Selling or spinning off captive/wholesale broker-dealer distribution or investment adviser businesses when both are currently operated within a larger financial services company;
- Rebranding proprietary funds to make them more attractive to other broker-dealers and distribution channels; and
- Reexamining the purpose and application of Rule 12b-1 and determining whether it needs to be amended.

These and other ideas will be debated during 2006. However, while any prospective regulatory changes could well affect distribution practices, the fund industry's own ideas and innovation may well prove to be most impacting.

Regulatory Compliance

In 2005, approximately 500 fund CCOs gathered for the first national SEC Fund CCO Conference to share views and promote efforts to protect fund shareholders and work to preserve the industry's culture of fiduciary responsibility and accountability. This session also provided a window into some SEC compliance hot spots for 2006, including trading practices and levels and use of commissions (soft dollars); allocation of investment opportunities; performance reporting; fair valuation practices; anti-money laundering practices; and e-mail policies and procedures. In view of the stakes, regulatory compliance will continue to be a top priority in 2006.



Looking Ahead, We See Change

Fund management and directors can be expected to continue to keep an eye on some key areas in which changes and fresh thinking may emerge during 2006. Six of these areas are explored in detail below:

1. Meeting Increased Requirements and Expectations of Fund Directors
2. Taking the Next Steps in Compliance
3. Renewing the Advisory Contract
4. Understanding, Evaluating and Reporting Matters About Controls
5. Dealing with an Uncertain Tax Horizon
6. Providing Better Communications

1. Meeting Increased Requirements and Expectations of Fund Directors

The role of mutual fund directors continues to be front and center. Short of any fundamental governance reform or rebalancing of management and director duties and responsibilities, neither of which is in sight, directors will push ahead to meet requirements and expectations.

Fund directors are getting help. The role of independent directors is being strengthened through the work of the Mutual Fund Directors Forum and the Independent Directors Council. Each of these organizations contributed to public policy discussions in 2005, providing comment letters on proposed rulemaking and/or publications on matters of interest to directors, and hosted conferences and meetings of directors, regulators and industry leaders.

Significantly, mutual fund boards (overseeing funds that rely on certain exemptive rules) are now required to conduct self-assessments annually. (The Independent Directors Council reportedly has confirmed with the SEC staff that the first self-assessment must be completed no later than January 17, 2007.) Directors may want to discuss with legal counsel the status of the applicability of this self-assessment requirement to their situations and, if required, develop a process to execute the assessment. In this initial period much discussion is underway about early questions:

1. Does the self-assessment pertain to each director, in addition to the board and its committees?
2. Are assessments planned to be shared among all directors – affiliated and independent?
3. Who should oversee the assessment process?
4. What constitutes an effective or successful assessment?
5. How should the board document the assessment?

Some directors have asked that, if the self-assessment process works well and confirms that the directors have exercised effective oversight of fund matters, could it eliminate the need for a policy regarding mandatory retirement age? Others remain mindful that many governance experts believe that a mandatory retirement age is still the preferred practice.

The “independent board chair” rule will continue to be an important backdrop to governance activities undertaken at least during the first part of 2006 – although many fund organizations already have plans that will accommodate any outcome of the pending court review. In the event the rulemaking is overturned, the SEC may propose modifying the original rule’s provisions, retaining only the 75% independent director requirement. In this case, among other actions, it is also possible the SEC would seek to require that fund boards publicly disclose their rationale for the appointment of an affiliated director as chairperson.

Fund directors are encouraged to emphasize two pivotal attributes of sound governance practices: Manage the risks of “the regular and routine”; and affirm that the appropriate relationship with fund management is in place. Accordingly, directors might look at matters through a different lens than used in the past – for instance, by involving different directors in management meetings, asking to meet with different or new management representatives or expanding their sources of information – as well as shaping relationships with fund management that stress openness, accountability and putting fund shareholder interests first.

2. Taking the Next Steps in Compliance

Over the past several years, the brightest spotlight in the fund industry has shined on compliance. Since its adoption in December 2003, SEC Rule 38a-1: Compliance Programs of Investment Companies and Investment Advisers (“the Rule”) has become the industry’s regulatory engine – driving an unprecedented level of oversight, review, evaluation and remediation of compliance-related controls. Fund organizations and boards have focused keenly on the Rule’s requirements and committed significant resources to its implementation.

In a few months, mutual funds will have completed annual reviews of their compliance policies and procedures – including determining the effectiveness of their implementation. The report of the fund CCO will close the Rule’s first chapter – and work will continue on the next chapters. There will be ongoing efforts toward three objectives:

Rationalizing Compliance Structures

The responses to the industry’s trading scandals and adoption of Rule 38a-1 were broad and swift. Understandably, immediate changes were made to fill gaps and solve specific problems at hand – although often ahead of developing an operations architecture integrating governance, risk and compliance activities.

In the Rule’s aftermath, some fund organizations – particularly those that are part of larger and diversified financial services companies – will benefit from reexamining the collection of current oversight units and their intended coverage of compliance-related activities as a way of bringing greater organization clarity; better defining roles and responsibilities; leveraging different activities in a more complementary manner; and reducing any risks of costly redundancies or, conversely, unintentional gaps among compliance activities.

Sustaining the Progress Made

Some fund organizations’ work to date has evolved in the form of “project management offices” or new “programs.” In such circumstances, these fund organizations likely will begin to turn their attention to embedding, in a thoughtful manner, all or a good portion of these activities in appropriate organizational units or operations. This integration should increase the likelihood that achievements and momentum in place are carried forward over the next few years.

Leveraging Technologies

The industry’s work on monitoring and testing legal and regulatory compliance activities – often across and throughout numerous service providers – confirms the need for more robust and flexible systems to achieve greater testing effectiveness and efficiency.

Fund organizations should continue establishing an enterprisewide platform of technology-based preventative and detective compliance-related controls. New business system applications, or enhancements to existing applications (such as trading, fund accounting, transfer agency, etc.), should be designed and implemented with control routines which aim to prevent compliance violations and identify exceptions. These control routines should incorporate forensic means to identify data anomalies or unexpected transaction trends that may indicate weaknesses in policies, ineffectiveness in the implementation of policies, or intentional misconduct.

3. Renewing the Advisory Contract

At the 2005 PricewaterhouseCoopers Forum for Mutual Fund Audit Committees, one-third of the directors polled indicated that management fees and other fund expenses represent their greatest concern over the next few years.

A new requirement for disclosure in reports to shareholders of material factors that fund directors considered (and their conclusions about such) when voting to renew a fund's investment advisory contract has focused directors' attention on their responsibilities in this area. In this regard, legal counsel continues to have an important advisory role with respect to the "15c" process used; information requested, prepared, and/or reviewed; and other matters that should be considered by directors in determining whether to renew the fund's advisory contract.

As part of the advisory contract renewal process, the adviser and fund board consider many quantitative and qualitative factors pertinent to an evaluation of the adviser's capabilities and performance. These often include the fund's investment performance relative to established benchmarks and peer funds, the competitiveness of the adviser's fee, the adviser's profitability after considering its costs, "fallout" benefits the adviser realizes as a result of providing investment services to the fund and some consideration of economies of scale.

Among other aspects of the evaluation, attention continues to be paid to profitability information developed by the adviser. However, in the absence of a single reporting approach, emphasis by fund directors and the adviser must be placed on establishing an agreed-upon reporting framework (including identifying any desired supplemental disclosures) and expectations about processes to be used in developing the information. In the past, some organizations have used an ad hoc process to develop and present profitability information. Other organizations use an integrated financial reporting model that leverages existing financial and management information systems and other data used in business decision-making. Also, in some large, diversified financial services organizations, business unit personnel participate in developing profitability information (providing their knowledge of the specific fund-related business activities). And, some fund boards and advisers choose to work with outside consultants as a means of assisting them in thinking about the reporting framework and related processes.

In facing regulatory and market pressures when overseeing fund fees, fund directors are also mindful that obtaining the "lowest fees" should be considered in conjunction with the best interests of shareholders. That is, "lowest fees" should not come at the expense of longer-term investment performance and high quality services. Active discussions about this area can be expected throughout 2006 in furtherance of fund shareholder interests.

4. Understanding, Evaluating and Reporting Matters About Controls

The combination of new legislation, regulations and changes in audit standards has inspired fresh discussions about the implications of these actions among fund directors (audit committees), fund counsel, fund management and independent auditors. Today's requirements can be summarized as follows:

1. Fund management provides periodic certifications in SEC filings concerning the fund's disclosure controls and procedures and internal control over financial reporting, including certifications of affirmative actions relating to these areas taken by fund management.
2. Independent auditors are required to disclose in their Form N-SAR letter any material weaknesses in a fund's internal control over financial reporting that were identified during the audit of the fund's financial statements.
3. Independent auditors also are required to report to fund management and audit committees any material weaknesses and significant deficiencies in a fund's internal control over financial reporting that were identified during the audit of the fund's financial statements.

In meeting their responsibilities, fund management and auditors need to apply the new definitions of material weaknesses and significant deficiencies (consistent with those specified in Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements* (AS2)).

PricewaterhouseCoopers' experience with this new reporting regime shines a light on three imperatives:

- Fund audit committees, counsel and management and independent auditors should discuss the relationship of disclosure controls and procedures and internal control over financial reporting and definitions of material weaknesses and significant deficiencies, so that the basis of related determinations made in auditor reports and communications and fund SEC filings is known.
- Fund management needs to be satisfied that any significant information relevant to its reporting responsibilities – including results of controls testing – is provided on a timely basis, including information (and auditor reports) pertaining to external service providers.
- Fund management should be alert to the possibility that any weaknesses in a fund's internal control over compliance – as identified by the fund CCO or others – may bear upon evaluations or communications concerning a fund's disclosure controls and procedures and internal control over financial reporting.

PricewaterhouseCoopers has developed a series of frequently asked questions and answers to assist fund management and directors in understanding these new requirements and definitions. This material is available through your PricewaterhouseCoopers representative.

5. Dealing with an Uncertain Tax Horizon

Planning for and managing change arising from new or possible legislative and regulatory tax actions will require attention during 2006.

While 2005 lacked a signature piece of tax legislation, important issues were considered including fundamental tax reform and extending tax cuts which are due to expire between now and 2010. For example, absent relief, tax rates on dividend income and capital gains will rise after 2008 and more taxpayers will become subject to the alternative minimum tax. At the same time, there is increasing concern that differences between the U.S. and international tax systems negatively affect the competitiveness of American companies.

Much of the focus in 2005 was on the deliberations of the President's Advisory Panel on Federal Tax Reform and its report, "Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System," issued in November 2005. It presents the case for tax reform and provides two distinct paths to significant change. The investment management industry may benefit if proposals to eliminate existing impediments to saving and investment are enacted. While tax reform was expected to be a major part of the President's 2006 economic agenda, legislative priorities have shifted. Moreover, some of the Panel's recommendations have attracted significant opposition. It now appears that President Bush may defer proposing fundamental tax reform at least until after the 2006 elections.

The President's 2007 budget proposes to permanently extend the individual tax cuts enacted in 2001 and 2003. However, the proposal faces Congressional opposition due to its cost. Democrats also view the benefits as skewed toward higher bracket taxpayers. Uncertainty about the fate of these tax cuts is increasing. In this environment, mutual fund organizations can be expected to think about their shareholder communications strategies in view of a possibly changing tax landscape and the potential impact of tax changes on fund products and supporting systems and operations.

One of the industry's top tax priorities is enacting legislation that would allow individuals to defer tax on reinvested fund capital gain dividends. While this legislation continues to have support in Congress, its chances also may be dampened by its potential cost.

From a regulatory perspective, those responsible for mutual fund tax oversight will be planning in 2006 for the possible implementation of a FASB proposal on accounting for uncertain tax positions. Under the proposal, scheduled to become effective in 2007, some mutual funds could be required to record provisions for income and/or excise taxes in their financial statements – reducing net asset value/share. Because of that possibility, fund management should carefully assess the technical merits of any uncertain tax positions taken by its mutual funds, and fund directors should keep informed of the accounting standard rulemaking process and fund management's evaluation of this area.

Product development promises to be a hot topic in 2006 following an IRS ruling issued late in 2005 that significantly restricts a mutual fund's ability to invest in commodity swap contracts. Fund sponsors are exploring the permissible use of commodity and certain other derivatives in mutual funds. The adverse consequences of the ruling reinforce the need to consider tax risks in developing new fund products.

6. Providing Better Communications

“He mobilized the English language and sent it into battle...”

Edward R. Murrow, on Sir Winston Churchill

Whether as an orator or author, few should disagree that Britain’s former prime minister had a keen sense of principles of effective communication – a conviction about the message, a willingness to provide the whole picture, an appreciation of the consequences when misunderstood, and a recognition that the elusive art is brevity not duration.

These principles can be applied equally to investor communications. In today’s environment, opaque operations or, worse, omitted or contorted disclosures can lead to investor suspicions that what has been obscured or passed over is likely in favor of the managers, rather than the shareholders. While safeguards must be maintained for information whose disclosure can violate privacy or relates to proprietary business matters, providing the complete story on a timely basis engenders a level of trust consistent with fiduciary responsibility.

The SEC will continue to encourage the fund industry to create new ways to provide investors with easy-to-understand information (as most recently evidenced by its offer of expedited reviews of registration statements and annual reports for companies that file financial reports with interactive data using XBRL). The SEC’s intent is also evidenced in SEC Chairman Cox’s remarks made in December 2005 before the Economic Club of New York, “If the SEC is truly to succeed in helping investors and in ensuring compliance with the law in the securities industry, we’ll need nothing less than an all-out war on complexity.”

As the SEC and the fund industry undertake their planned reexamination of the current disclosure regime (and, as part thereof, consider corresponding and equitable legal protections), Mr. Churchill’s dismay, expressed years ago, provides still another incentive to help investors:

“This report, by its very length, defends itself against the risk of being read.”

PricewaterhouseCoopers values our long-standing relationship with the U.S. mutual fund industry. We look forward to assisting the industry in 2006 in its endeavors to serve the interests of its fund shareholders.

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