Looking Ahead: Strengthening the Structural Foundation of the U.S. Investment Management Industry—Internal Control*

2007

*connectedthinking

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January 2007

Dear Clients and Friends,

At the beginning of each year, PricewaterhouseCoopers provides management and those having governance roles in the U.S. investment management industry —comprised of registered and alternative investment funds—views about important areas of the industry that we believe merit attention during the coming year. As we enter 2007, most observers believe the industry outlook remains positive; with expectations that it will continue to grow (given cooperative world economies and markets) through developing, marketing and distributing high performing investment products with fair and competitive fees, while providing quality service to investors.

Yet it's also hard to recall a period of time as full of legislative and regulatory uncertainty, one marked by the likelihood of fundamental, unparalleled change within our financial systems. Similarly, it's difficult to recall a period when the operating complexities of the U.S. investment management industry have been as striking. Adding to these challenges, investors are rightly holding the industry to high fiduciary and ethical standards and demanding transparency. It seems that investors are being heard as never before.

This mix of forces requires the industry to continue investing in its structural foundation—internal control directed at the achievement of financial reporting, compliance, and operations objectives—so that it remains strong enough to meet the significant challenges these forces pose. In 2007, the industry's vigilance and work in the area of internal control will be an important factor in maintaining investor confidence. As we have witnessed time and time again, investors' faith in the industry is renewed more through its actions than its words.

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In this publication, we first provide a brief synopsis of today's industry environment. Then we present our observations about five areas of internal control with important ramifications for the industry; and we offer suggested practices to address challenges seen in each area.

We hope you find this information helpful in meeting your management or governance responsibilities in 2007.

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Industry snapshot

The U.S. investment management industry enjoyed a robust 2006; benefiting from a resilient domestic economy, strong markets in many other areas of the world, relatively low inflation and interest rates, and an ample supply of investor funds. The industry achieved positive business results across a spectrum of traditional and new investment products.

Substantial asset growth

During 2006, the combined assets of the nation's mutual funds passed $10 trillion for the first time, and nearly half of U.S. households now own mutual funds[1]. The broad appeal of mutual funds is readily evident in middle America for both general and retirement investing purposes. Looking ahead, the provisions of the Pension Protection Act of 2006 may well provide the mutual fund sector an additional spark in the form of more cash inflows targeted for retirement investments.

Sponsors of exchange-traded funds (ETFs) also enjoyed impressive results in 2006. Through November 30, 2006, the number of ETFs grew more than 65% over 2005; and total ETF assets grew approximately 34% during the same period.[2] Further, in 2006, many investment management firms, including traditional mutual fund organizations, first launched or added to their suite of separately managed portfolios. This move was in response to the growing demand for these lower cost investment structures and more flexible investing strategies by institutional and wealth management clients.

Alternative investment funds continued their own remarkable growth story last year as well. Hedge funds, excluding fund-of-funds, increased their invested assets by 29% over 2005, to an estimated level of $1.43 trillion.[3] This was achieved despite the liquidation of some portfolios, performance pressures in selected investment strategies, and some restraint seen in investor allocations. Event-driven funds were particularly strong asset-gathering vehicles in this sector in 2006.

Similarly, private equity funds, propelled by investment momentum for leveraged-buyout transactions, raised record amounts in 2006. Many funds posted impressive returns relative to those of major stock indices. Fund valuations were pushed higher, in part due to an increasing pool of available investor funds and sharpened competition among investment managers for companies of high investment worth.

Yet, as often mentioned, past performance may not be an indicator of future performance—so 2007 begins with both optimism and the realization that each sector within the U.S. investment management industry faces challenges in sustaining the momentum of 2006.

Continued convergence

Unquestionably, there is a growing interest by the capital markets in the alternative investments sector. More and more of this sector's investment management firms—and in some cases, the funds themselves—are accessing the capital markets. For example, last year, an alternative asset manager announced its plan to go public—representing the first registered IPO of its kind in the United States. And, in December 2006, a hedge fund effected the first-ever sale of bonds, through a medium-term note program. In some respects, the current needs of many alternative investment firms are not substantially different from the needs of some large financial institutions ten years ago. Some refer to this evolution as the sector's 'institutionalization.' The sector's challenge is, of course, while becoming more institutionalized—to also retain its entrepreneurship.

Also, in the private investment marketplace, older lines between some of its subsectors continue to converge and blur. Some hedge funds are increasingly incorporating multi-investment strategies, including increasing their allocations to private investments; joint ventures between or among hedge fund managers, private equity firms, and real estate managers are being seen; and structured products are being used both for a fund's investment and financing purposes.

Focus on innovation

In the PricewaterhouseCoopers "Global Investment Management Survey 2006," chief executive officers of investment management firms cited new product innovation and development as one of the key strategies they will implement over the next three years to maximize the success of their businesses. Indeed, many of the market changes and forces observed throughout 2006 provide a strong signal that investment product remains the engine of growth. Many investment management firms are redirecting their product development and distribution efforts to capture the expected higher flows of funds arising from shifts in investment interests or needs of retail and institutional investors. These shifts can be observed in the proliferation of lifetime income products for retirees; and in increasing institutional investor attention to less developed and nontraditional asset classes, such as life insurance contracts, drug royalties, and subrogation claims. In 2006, the first private equity ETF was launched, and additional private equity fund-of-funds were made available to institutional investors and high net worth individuals by major securities firms.

Further, the broadening of offerings is not only occurring through new product development. Last year also produced a high level of merger and acquisition transactions, as "long only" and "long focused" investment management firms sought ready access to more and different alternative investment strategies.

More generally, new investment products can be expected to address the following:

- the need of an aging U.S. population for additional retirement income generation, predictability, and sustainability over expected longer lives;
- the desire and need of public and private pension systems and nonprofit organizations to increase their investment diversification and participation in higher-performing asset classes; and
- a growing appetite on the part of more and more investors—institutions and, increasingly, individuals—for higher absolute investment returns.

Uncertain environment

As the New Year's first pages are turned, the industry's challenge in contending with these market forces is made even more difficult by an uncertain legislative and regulatory environment. Consider the following:

- The 110th Congress is being led by Democrats in the House and Senate; a setting last seen in 1994.
- Recently the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) issued significant proposals that focus on changes in management assessments and audits of public companies' internal control over financial reporting (commonly referred to as 'Sarbanes-Oxley Section 404' management assessments and audits).
- The Committee on Capital Markets Regulation, composed of business leaders and policy experts, is advocating more balance between the drivers that strengthen the competitiveness of U.S. markets and those that preserve their integrity and reliability. Some investor groups are in outspoken opposition to many of the views of the Committee.
- Market structures are evolving throughout the world, as seen in the rise of cross-border acquisitions and mergers, electronic communication networks, and for-profit trading markets. This trend has significant ramifications for the trading operations business model of many investment management firms.
- There is a continued movement toward combining the regulatory oversight and enforcement functions of the New York Stock Exchange and the NASD.
- Many expect significantly enhanced Congressional oversight of a broad range of industries and issues. Among other areas, Congress is keeping close watch on hedge funds, at a time of increased investments by pension plans in hedge funds. At the same time, viewpoints about the benefits to the U.S. capital markets system of hedge funds and other alternative investments can be expected to continue to be articulated by some in 2007.
- The SEC recently proposed new rules affecting certain pooled and private investment vehicles, including hedge funds, concerning "accredited investor" provisions and antifraud measures.
- The SEC is continuing to focus on governance matters, seen in the form of a new e-proxy rule and the Commission's intent to further address the economic or cost considerations of the much-debated "independent fund chair" rule proposal.

- A new “compliance association” was recently established, mainly comprising chief compliance officers representing alternative investment firms. The association intends to develop and share leading practices for handling regulatory compliance and operational issues. Separately, other hedge fund sector participants are exploring the desirability and feasibility of establishing a self-regulatory structure, to address broader public concerns about their sector’s operations and transparency.
- Regulators are concerned about insider trading and the possible increased misuse of material nonpublic information by some market participants.
- The SEC is moving ahead rapidly on its “interactive data” filing and disclosure software platform, and enthusiastically articulating its promises to both companies and investors. The Investment Company Institute (ICI), working closely with its XBRL Working Group (comprised of ICI member firms, regulators, service providers, and investor advocates) and PricewaterhouseCoopers, recently announced the completion of a draft XBRL taxonomy for the risk/return summary of a fund’s prospectus. Following a public review period and any resulting modifications to the taxonomy, the ICI is expected to announce the availability of the taxonomy for use in SEC filings.
- A growing number of voices are expressing the need for a fresh review of critical provisions of the 1940 Acts pertaining to investment companies and investment advisers. This is a response to the evident difficulty and stress in applying certain provisions of an older framework to current market circumstances.
- Regulators and political bodies elsewhere in the world, separately and collaboratively, are considering and reviewing systemic risks in national and world financial systems; administrative standards or guidelines for use by hedge funds; and oversight of private equity funds.

Against this backdrop, the remainder of this report addresses five key areas of internal control:

— Managing potential conflicts of interest

— Overseeing third-party service arrangements

— Addressing the risks and reporting of complex investment strategies and financial instruments

— Bringing more focus to tax matters

— Staying alert to other potential risks

Each of these areas is significant to the operations of the U.S. investment management industry in 2007—and to investors’ confidence in those operations. For each area, current challenges and PricewaterhouseCoopers’ suggested practices for dealing with them are presented.

1.

Managing potential conflicts of interest

The roots of potential conflicts of interest in the investment management industry extend back to the first-ever adviser and client relationship. However, after decades of evolving marketplace structures and business practices, today's roots are larger in number, broader in dimension, and greater in complexity.

More than 65 years after their adoption, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 (and related rules, regulations and interpretations) continue to be the main focal point of the industry's framework for avoiding many conflicts of interest and managing other potential ones. This legislation has served investors well. More recently, the issuance of SEC compliance program rules and staff guidance have noticeably raised expectations for registered investment advisers and investment companies to properly identify and manage potential conflicts of interest.

Causes of potential conflicts

This emphasis on managing conflicts of interest is particularly important as more and more forces affecting today's investment management industry stretch its fiduciary fabric, among them:

- The expanding labyrinth of business roles or capacities, beyond investment adviser, in which many financial firms serve their investment management and other clients;
- The growth of proprietary or firm trading activities in many securities firms, as they seek to boost earnings;
- The presence of side-by-side investment management activities, most commonly cited when an adviser, and sometimes its portfolio manager, manages both mutual funds and hedge funds;
- The practice of shared revenue arrangements; and
- The intersection of investment management, recordkeeping services, and fund governance responsibilities in the corporate retirement area.

While these and other forces inevitably raise questions about potential conflicts of interest, many of them are cited as providing benefits to investors as well.

In this environment, many investment management firms are taking a fresh look at their existing relationships and business arrangements to confirm their nature and purpose as well as the adequacy of their current disclosures. Additionally, they are assessing the sufficiency and reliability of internal programs, processes, and systems to identify potential conflicts of interest arising from new business circumstances and, in those circumstances where the existence of potential conflicts is not prohibited, to effectively manage them.

Suggested practices

- ***Embrace evaluation of conflicts of interest.*** Conflicts of interest are often considered the 'third rail," and people sometimes can be incurious about them. Nevertheless, these situations exist in the investment management industry—at least inherently or potentially. The culture of investment management firms should embrace open, thorough, and objective study of underlying circumstances giving rise to potential conflicts.

- ***Develop objectives, dimensions and reporting protocols for a conflicts management process.*** Management and directors should (with advice from counsel) mutually agree on the objectives, dimensions and reporting elements comprising a conflicts management process. The *objectives* might relate to such matters as preserving firm reputation, establishing desired ethical practices, and ensuring and enforcing compliance with laws, regulations, and firm policies. The *dimensions* might consider the desired reach to, and handling of, affiliated and unaffiliated entities, lines of business, business policies (such as gifts and entertainment) and business practices (such as internal compensation systems), investment products, directors, officers, agents, counsel, auditors, and service providers. The extent to which familial relationships are expected to be addressed should be made clear as well, not left in ambiguity. Particular attention should be applied to relationships with third parties, and to fund-related circumstances that provide direct or indirect benefits to the adviser. The *reporting protocols* should specify the manner in which information about conflicts of interest is to be communicated (including escalation routines) and discussed.

- ***Implement a conflicts management process.*** Each investment management firm should employ a comprehensive and continuous conflicts management process, effected by those charged with governance. The goal should be to provide assurance that all new and ongoing business activities and relationships (institutional and, when appropriate, individual) are:

  — examined and monitored for potential conflicts of interest;

  — compared with relevant statutes and regulations for permissibility;

  — assessed for relative business risk, including reputation risk;

  — disclosed in clear terms in appropriate filings and documents, and to appropriate parties (directors, investors, auditors, etc.); and

  — handled in a manner that reduces any risk of investor harm.

  Ad hoc approaches to matters in this area—regardless of the relative size and degree of simplicity or complexity of the firm's business activities—should be discouraged. The conflicts management process should be documented, and both the underlying analysis and all affected disclosure documents should be kept current.

- ***Identify parties with responsibility for relationships and activities that could create potential conflicts.*** An effective conflicts management process requires the identification of parties with responsibilities for overseeing and managing potentially tangled relationships and activities, and remediation of any identified problems. Identifying the appropriate parties requires careful evaluation of the potential specific risks at hand. Chief compliance officers often have a role in this area but the nature and extent of the roles and responsibilities of other parties, as well, should be discussed and agreed upon by management and those charged with governance.

- ***Use technology to help identify potential conflicts.*** Firms should look to technology applications as one means to identify potential conflicts of interest arising from relationships and transactions or anomalies in information and other data. Technology should also be used to produce information in a manner conducive to the performance of efficient and effective reviews.

2.

Overseeing third-party service arrangements

Outsourcing in the investment management industry comes in many shapes and sizes. It is performed both onshore and offshore, often through the use of third-party service providers (e.g., subadvisers, distributors, administrators, custodians, transfer agents, shareholder service agents, and printing firms).

For some investment management sectors—particularly registered investment companies and investment advisers—third-party service providers sometimes perform all or the bulk of the entity's operations or activities. For hedge funds, outsourcing typically comprises fund administration services.

Outsourcing on the rise

In the investment management industry, there is a continuing evolution and use of new and increasingly complex investment strategies and underlying financial instruments, often employing a global trading platform. In addition, there is a growing dependency on technologically advanced, cost-efficient and functionally capable middle-office and back-office servicing organizations. These trends will likely push investment managers to increasingly outsource key asset-servicing functions; particularly, in the more rapidly growing alternative investments sector. Many managers will look to expend their human resources in ways to achieve higher performance in an increasingly competitive investment environment, and avoid the costly chase of keeping their infrastructure and systems current to meet the demands of greater and greater investment complexities. Service providers, on the other hand, will seek to capitalize on their scale for traditional services (such as custody) and promote aggressively newer and distinctive services (such as middle-office activities and knowledge process outsourcing). In this environment, oversight of third-party service providers is an essential element of the fund's or investment adviser's internal control. Its importance is seen in a current study underway by the Independent Directors Council (IDC), a body serving the mutual fund independent director community. The IDC's objective is to develop and publish, in early 2007, guidance and leading practices for boards to consider in their oversight of service provider activities.

Delegation, not abdication

There is no "one size fits all" approach to overseeing service providers; practices vary considerably. Differences can be observed in provisions of service contracts relating to parties' obligations and responsibilities. As well, other differences are evident in actual practices used—as in who performs the oversight, the nature of the oversight, and the frequency of the oversight. However, one common aspect of service provider oversight among all funds, investment advisers, and other similar entities should be the overarching philosophy embedded in the arrangements—*namely, that delegation is not abdication.* Leading practices embrace the importance for funds and advisers to affirmatively determine that the delegated functions are being performed by the service provider in the expected manner, and that the delegating entity has examined sufficient evidential matter to provide reasonable assurance that information provided and reported by the service provider is reliable and that fund assets are adequately safeguarded.

Suggested practices

- ***Focus on due diligence.*** Management and directors should have a common understanding of the strategic and operational intents underlying existing and proposed outsourced or third-party service arrangements. In many cases, proposed arrangements demand the same nature and extent of due diligence activities that commonly are undertaken in the acquisition of a business. Directors should request and obtain information necessary for them to evaluate—with shareholder interests in mind—the likely benefits of the proposed strategy, the potential risks of the strategy, and the adequacy of planned oversight activities of, and reporting routines by, service providers.

  Beyond cost reduction (which, although some studies point to as a frequently cited motivation for outsourced arrangements, is also often a cause of dissatisfaction with such arrangements when cost reduction goals are not achieved), directors should understand the interplay of these outsourced arrangements and the adviser's core competencies and the fund's desired service quality, risk tolerance, and strategic flexibility. Management should ensure that contractual and fee arrangements between and/or among the adviser, fund, and service providers (and, when appropriate, other parties, such as subservice providers) are part of each outsourcing evaluation.

- ***Establish oversight objectives.*** Oversight of service providers is discharged both by those responsible for governance and by management. These parties' roles and responsibilities differ, but the efforts of each should be undertaken in respect of the same paramount objectives:
  - Is the service provider performing that which it is required to perform and has been asked to perform?
  - Is the service provider performing its activities in a manner consistent with the funds' or advisers' requirements and expectations?
  - Does the fund or adviser have a reasonable basis to rely on the information produced and reported?

- ***Create a robust, clear process for managing third-party service providers.*** The implementation and sustainability of effective oversight of third-party service providers by a fund or adviser require a robust and clear management process. That process should incorporate matters relating to strategy, objectives, authority, responsibility, tasks, resources, reporting, and particularly, accountability. The process should be aligned with and complementary to the activities undertaken by the service provider. Communication protocols between the parties must be the thread pulling the efforts together.

- ***Ensure that all parties understand their roles and responsibilities.*** In multi-service provider arrangements, particularly, management should determine that no unintended gaps exist in the respective parties' understanding and acceptance of their roles and responsibilities. Contractual provisions typically provide formal checks in this regard, but more detailed or specific understandings—often achieved through the use of service level agreements—are leading practices.

- ***Monitor performance.*** Management should maintain a dynamic and rigorous monitoring process with respect to service providers' responsibilities and performance in meeting the fund's or adviser's operations and compliance requirements. The process should incorporate the use of key risk indicators and agreed-upon performance metrics. Management should continuously review the information needs of funds or advisers as their operating circumstances change. Communication protocols should be in place so that funds and advisers are apprised timely of significant determinations or judgments made by service providers on their behalf.

- ***Ensure the nature of third-party reports is consistent with their intended use and that the period of testing is recent and of sufficient duration.*** In connection with its oversight processes, a fund or investment adviser may consider information contained in third-party audit or similar reports of a service provider's activities. Among other things, this information is one of many inputs for determinations made in connection with Sarbanes-Oxley Section 302/906 certifications filed periodically with the SEC and SEC Rule 38a-1 and 206(4)-7 annual compliance reviews undertaken.

  In these instances, management should ensure that 1) the actual subject of the assurance or review contained in the third-party report meets the purpose and intended scope of its oversight process (i.e., financial reporting or compliance objectives); and 2) that the period of testing covered by the report is recent and of sufficient duration for its purposes. If there is no available third-party report that provides information about a service provider's controls directed at financial reporting or compliance objectives, and the outsourced operations are significant to the fund or investment adviser, management typically has two paths available to it. The first is for management to request the service provider to provide an independent accountant's compliance attestation, SAS 70, or agreed-upon procedures report or other third-party report for use as an additional component of its oversight process. The second is for management to undertake its own review of the service provider's internal control directed at the achievement of specific objectives relevant to its funds' or advisers' circumstances.

- ***Use technology to confirm information integrity and identify anomalies.*** Firms should incorporate technology applications in the oversight process to confirm the integrity of reported information and better identify any anomalies within the information.

3.

Addressing the risks and reporting of complex investment strategies and financial instruments

In search of distinctive investment performance, investment managers and Wall Street innovators are collaborating to identify increasingly sophisticated and often nuanced investment opportunities. Recent examples include structured credit derivatives, PIPEs (private investments in public equity securities), and a return to favor of certain forms of tailored structured debt instruments. Further, a number of alternative investment funds are venturing well beyond investments in securities and commodities into nontraditional asset classes, including reinsurance, loans, real estate and structured products.

It may be that perceived investment opportunity is driving the development and manufacture of the financial instruments or, conversely, that the availability of new financial products is forming new investment strategies. In either case, one thing is clear: the investment management industry is increasingly making investments whose full features (including their benefits, risks, direct and indirect obligations, accounting and tax characterizations, as well their designed interaction with other financial instruments or indices) give rise to knotty accounting analysis. This complexity, challenging even for investment professionals, is straining many operations groups charged with managing enterprise or fund risks and performing the financial and tax accounting and reporting activities associated with these instruments.

Impact of FAS 157

At the same time, U.S. investment managers are turning their attention to a new accounting standard issued in September 2006: Statement of Financial Accounting Standards No. 157 (FAS 157). FAS 157 will be extensively used by the financial reporting community, including financial services firms and their sponsored funds. The new standard amends over 20 other FASB standards, including those pertaining to debt and equity securities, servicing rights for financial assets, and derivatives. Entities are not required to apply FAS 157 in their financial statements until early in 2008. Many investment managers have, however, already begun to assess the standard's provisions and their potential effect on fair value measurements for financial reporting and, in turn, performance reporting to clients.

FAS 157 establishes a common definition of fair value under U.S. generally accepted accounting principles for all reporting entities. It also establishes a single framework for measuring the fair value of all financial and nonfinancial assets and liabilities required or permitted to be reported or disclosed at fair value, with limited exceptions. (Note the term "fair value" as used in FAS 157 is more similar in meaning to the overall term "value" as used in the Investment Company Act of 1940 than a good-faith board-determined fair value.) Although FAS 157 does not address *when* fair value should be used in financial statements, it can be expected to change the methods some entities use to measure fair value. For example, for registered investment companies which value specific securities at a board-determined "fair value," it may be necessary in some instances to make changes to the underlying valuation methods currently applied to be consistent with FAS 157's single fair value framework.

Generally, the financial services industry already has reasonably established external pricing and valuation sources, as well as internal modelling capabilities, to strike reliable fair value measurements. Nevertheless, the standard introduces new concepts and required disclosures which may change current practices in some circumstances, such as:

- requiring the use of an “exit price” to value long positions (the price an entity would receive if it were to sell the asset in the marketplace) rather than an “entry price” (the price an entity would pay to acquire the asset);
- clarifying that the term “fair value” is intended to mean a market-based measure, not an entity-specific measure, and introducing the notions of *principal* and *most advantageous* markets;
- requiring that entities measure fair value using a valuation technique (or a combination of techniques) that is appropriate to each entity’s circumstances and for which sufficient data is available;
- establishing a three-level hierarchy of inputs to be used in measuring fair value, intended to prioritize the use of observable inputs (either direct, as in quoted prices for securities traded in active markets, or indirect, as yield curves, credit spreads, etc.); and permitting the use of unobservable inputs for situations in which there is little, if any, market activity for the asset or liability being measured (e.g., a company’s internal information which cannot be corroborated by observable market data);
- prohibiting the use of a “blockage” factor when determining the fair value of securities which can be freely traded in an active market; and requiring that fair value measures be based on the amount that a marketplace participant would demand to assume the risk resulting from the inability to access a public market for a security with restrictions on its sale or transferability; and
- mandating additional disclosures, including the breakdown of fair value measurements by hierarchy level and information about assets and liabilities measured using unobservable inputs. For some types of funds, that will mean disclosing specific information, more than provided in the past, about the overall composition of fair value determinations throughout the portfolio, and the general methodologies used to determine fair values.

The extent of reporting changes arising from FAS 157 can be expected to vary widely among investment managers, largely depending upon the investment strategies of their funds and portfolios and the underlying assets held or obligations assumed—including such factors as the funds’ access to different reference markets and the liquidity of their holdings and obligations. Certainly, holdings that only trade on a limited basis, or obligations embedding sophisticated structures, such as some equity and credit derivatives, will require careful review by investment managers. While the application of FAS 157 is likely to be less complex for registered investment companies than, for example, a hedge fund trading in inactive markets, several aspects of this new accounting and reporting framework will deserve attention in 2007 by all funds who have positions to report or disclosures to make based upon fair value measures.

Suggested practices

- ***Review current policies, practices and assumptions related to securities valuations.*** FAS 157 provides an opportunity for investment management firms to take a fresh look at all their current policies, practices, and assumptions used in securities valuations. In addition, as part of the mapping process of holdings to the three-level fair value hierarchy, the standard provides an opportunity to reaffirm the appropriateness of existing reference points used (e.g., determining which bid-ask range practices may be most representative of an "exit price" in the circumstances), or to seek more appropriate alternatives. As firms review these practices, they should ensure that documentation is developed supporting the decisions made. Also, firms should use this implementation period to enhance, clarify, and harmonize, to any extent necessary, valuation practice disclosures among offering documents, partnership agreements, contracts, and financial statements.

- ***Focus on broader business and internal control issues over valuations, beyond the accounting department.*** The effects of added complexities in financial instruments, and new developments in corresponding financial accounting and reporting frameworks, will be felt more broadly than just within accounting policy departments of financial services organizations. These organizations will need to focus on broader business and internal control considerations. Firms' investments in operations and technology applications will be expected to keep pace with these changes. Some firms will undertake new evaluations of the adequacy of the level and skill sets of supporting personnel. Others will take a fresh look at internal reporting lines, to affirm there is clarity of responsibilities and appropriate segregation of duties among oversight, investment management, and operations personnel.

- ***Begin considering how to implement FAS 157.*** Investment managers should begin to consider FAS 157 and other fair value developments in the context of their funds' investment strategies, holdings, and obligations; current sources of prices and valuations; and the provisions of governing documents (e.g., prospectuses, contracts, and private placement memoranda). Fund organizations that use third-party service providers for valuation activities should ensure their expectations about implementing FAS 157 are communicated to and discussed with the service providers. Some private funds may need to review with investors and clients current understandings of valuation methods used; and, in some circumstances when desired by parties, private placement memoranda may need to be revised to permit departures from U.S. GAAP valuation methods. Further, periodic SEC filings that a public fund makes between now and when it adopts FAS 157 must comply with the guidance contained in SEC Staff Accounting Bulletin No. 74, *Disclosure of the Impact that Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period.*

- ***Affirm expected degree of commonality of valuations, and understand any differences.*** Where investment management organizations are run on a fund family, investment strategy, product, or business line basis, decisions can sometimes be made independently of one another. For these investment managers, implementing FAS 157, absent unique circumstances, should significantly reduce, if not eliminate, any differences in fair value measurements of identical or similar financial assets and liabilities held by different funds and portfolios. (SEC staff views already indicate that such

differences should rarely, if ever, occur within a group of funds overseen by the same board of directors.) Oversight processes, including those performed by fund directors, should include inquiry about the reasons for any such differences.

- ***Apply more oversight when results are significantly influenced by subjective information.*** The fair value hierarchy and related reporting should facilitate evaluating the extent to which portfolio performance is influenced by nonobservable inputs (subjective information). When fund results are significantly influenced by such inputs, greater oversight should be applied. That includes periodically checking the appropriateness of the pricing model(s) used, the integrity of the data used therein, and the sufficiency of controls over risk limits.

- ***Push some operations considerations forward to the front and middle offices.*** The control risks arising from the convergence of increasingly complex financial instruments and the application of a new fair value framework will present challenges to firms, particularly in daily NAV reporting environments. Some firms will benefit from rethinking how they might push more of the operations considerations further to the front (investment and trading) and middle (trade support) offices, to more timely understand the features of the investments and establish accounting and reporting protocols, without compromising internal control over the valuation process, including the desired segregation of duties and responsibilities.

- ***Be aware that responsibility for valuation of alternative investments cannot be outsourced.*** The industry continues to discuss fair value considerations involving holdings of alternative investments. Management of both investor entities (such as fund-of-funds) and investee entities should become familiar with the provisions of an AICPA Practice Aid issued in July 2006—most notably, including its provision that the responsibility for valuation of interests in alternative investments "cannot, under any circumstance, be outsourced or assigned to a party outside of the investor entity's management."

- ***Prepare for rigorous auditing of fair value measurements.*** Audit practices in respect of fair value measurements can be expected to be applied rigorously and thoroughly— particularly those established through use of internal company information. Auditors will place particular emphasis on the quality and quantity of supporting documentation prepared by investment management firms. The nature and level of evidence supporting fair valuations sought by auditors can be expected to generally correlate to the materiality, complexity, liquidity, and price volatility of the financial instruments. Hedge fund and private equity fund managers, in particular, should be mindful of an increased focus by institutional investors' auditors on the existence and valuation of their portfolio holdings and obligations.

- ***Directors and trustees need to keep current with fair value developments.*** Directors and trustees of funds require familiarity with developments affecting fair value determinations. They should understand how the new fair value hierarchy is expected to be applied in circumstances for which they have oversight responsibility, and the nature of any changes planning to be made to historical valuation or disclosures practices.

4.

Bringing more focus to tax matters

The investment management industry faces significant tax-related operational and compliance challenges from a combination of factors: the previously noted increased use of complex investment strategies and underlying sophisticated financial instruments, uncertainties in the application of tax regulations, and unforgiving consequences should a breach of regulations occur (particularly for registered investment companies).

The juxtaposition of this increased use of complex and sophisticated investment strategies (and financial instruments) and the generally static and older tax law in many jurisdictions has now produced an overhang of uncertainty in a number of tax determinations—particularly for alternative investment vehicles. And, importantly, this has occurred during a period in which compliance requirements imposed by federal and state securities laws and regulations and financial reporting obligations have necessarily claimed a significant and, likely, greater portion of the industry's operations and compliance resources (people and systems). As a result, highly skilled resources that can manage these tax risks have become an even more essential part of every management team in advisor and fund organizations.

Impact of FIN 48

It's expected that demands on tax resources will continue to increase noticeably over the near term; more so, in view of the industry's need to contend with a new accounting interpretation, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109* ("FIN 48"), issued in July 2006. In very general terms FIN 48, applicable to all of corporate America, prescribes, for financial reporting purposes, rules for the recognition, measurement and disclosure of the tax benefits arising from uncertain tax positions. FIN 48 is intended to reduce the diversity of practice in financial accounting for income taxes and applies to uncertain tax positions taken with respect to income-based taxes.

Many investment funds (including regulated investment companies) have never paid income taxes to federal and state jurisdictions. Nevertheless, FIN 48 is a significant pronouncement for registered and alternative investment funds, primarily because they customarily involve uncertain tax positions, to some degree. For example, Wall Street often creates financial instruments more quickly than the IRS can provide rules on their tax treatments. Further, in the case of regulated investment companies, it is not uncommon for a fund to rely on uncertain tax positions when determining its qualification as a regulated investment company or its income and gain amounts for distribution—such as determinations made in respect of asset diversification requirements and calculations underlying distributable gains and income relating to complex debt instruments and derivatives. Uncertain tax positions also include positions taken with respect to federal income and excise, state and foreign taxes on tax returns for all open tax years. FIN 48 will require that a fund's management—*using new and stricter accounting criteria established therein*—reaffirm or otherwise determine that no income-based taxes need to be accrued under U.S. GAAP in financial statements and reflected in the computation of daily or periodic net asset values.

In view of some of the unique tax-related circumstances and challenges facing registered investment companies, at the end of 2006, in response to a request by the ICI to delay the required implementation date of FIN 48, the SEC indicated it would allow registered open-end and closed-end investment companies, with calendar year-ends, to implement FIN 48 no later than June 29, 2007; and a calendar-year business development company to implement FIN 48 as of the last day of the period for filing Form 10-Q, which would be March 31, 2007. However, private investment funds are required to adopt the provisions of FIN 48 for U.S. GAAP reporting purposes in fiscal years beginning after December 15, 2006.

Suggested practices

- ***Evaluate the sufficiency of tax accounting and reporting resources of the sponsor and/or fund.*** In view of the complexities associated with tax accounting, reporting and compliance activities in general, and the already increased demands posed by FIN 48 in particular, many firms may find it beneficial to conduct a top level reassessment of the sufficiency of the sponsors' and/or funds' collective tax accounting and reporting resources—policies and practices, systems, processes, controls, and people. The assessment and any resulting plan for improvement should be reviewed with senior management and fund directors. The assessment should incorporate tax considerations in respect of both the entity and any reporting for the entity's shareholders (e.g., Form 1099) or partners (e.g., Form K-1).

- ***Develop FIN 48 implementation and sustainability plans.*** Successful adoption of FIN 48 will depend largely on two cornerstones: an implementation plan and a sustainability plan. Management should expect that additional procedures and time (which, in certain cases, may be significant) will be required to implement the components of each plan.

  A FIN 48 implementation plan should include the following components:

  — Overall approach: Incorporate a project management methodology and define the boundaries of the review (e.g., periods to be covered and documents to be inspected).

  — Resources assigned: Determine the roles and responsibilities of internal parties (including appropriate personnel outside the tax function); third parties; and any special advisers and counsel.

  — Tasks and timelines: Compile an inventory of uncertain tax positions for evaluation against the threshold criteria and the required timelines.

  — Evaluations: Outline the expected steps to be followed and considerations to be made in reviewing uncertain tax positions, obtaining required approvals of determinations made, and documenting positions taken.

  — Documentation: Determine the form and extent of documentation that will be necessary for management to establish that a FIN 48 evaluation was sufficiently completed and that supports statements made by specified officers of registered funds in their certifications included in periodic SEC filings.

— Communications protocols: Determine the manner in which senior management and fund directors are to be regularly apprised of work completed, findings made, and discussions conducted with auditors.

— Disclosures: Inventory current tax-related disclosures and evaluate their sufficiency (including transparency) for legal and financial reporting purposes.

A FIN 48 sustainability plan should address the means to support the evaluation and reporting requirements in this area on an ongoing and "real time" basis, including periodically assessing:

— whether new information (e.g., a change in law, new regulations or other guidance from a taxing authority, and comments by representatives of the taxing authority) has become available that changes a prior determination reached for FIN 48 purposes; and

— the implications of any new tax uncertainties arising from, for example, an investment in a new security, a fund merger, or a recapitalization.

The frequency with which management performs these assessments with respect to one or more uncertain tax positions will likely be influenced by a number of factors. Those factors include the materiality of an uncertain tax position to a fund, the rate at which the law or regulation corresponding to a position is evolving, and the frequency with which an investment fund reports its net asset value to investors. Management will need to balance the resources necessary to complete these assessments with the risk and consequences of a net asset value or financial statement reporting error arising from an inability to identify timely a change in an existing uncertain tax position or a new uncertain tax position.

- ***Develop written policies and procedures encapsulating significant FIN 48 implementation challenges.*** Among many implementation challenges embedded in FIN 48, investment management firms should be alert to developing written policies and procedures to:

— establish a consistent approach in determining when to first record a tax liability for NAV computation purposes, particularly in view of likely circumstances involving the consideration of imperfect or unclear data or other information;

— address implementation dates for FIN 48 in those unusual circumstances when an uncertain tax position both gives rise to recording of a tax liability and pertains to funds in a complex with different fiscal year-ends; and

— address implementation considerations arising from the possibility that, historically, different tax practices or determinations may be in place or may have been made, respectively, for individual funds within a fund family or complex—arising from mergers or acquisitions or other reasons.

5.

Staying alert to other potential risks

A fund's internal control—its design as well as effectiveness—is affected by numerous internal and external forces. Internal forces include, among others, changes in an investment adviser's business strategies; a fund's investment objectives; governance structures or the composition of individuals comprising such; technology applications used in trading and accounting operations; and findings arising from risk assessments made. External forces commonly include enactment of new statutes or laws, changes to existing regulations, a regulator's examination or inspection interests, the stability of markets, and industry business practices.

Relative shifts or changes in these forces inevitably means that areas of a fund's operations identified for closer review, evaluation and oversight continuously change, and the relative effectiveness of some controls may well go up and down (though, in the U.S. investment management industry, generally within an acceptable band of performance). In some cases, because of the interplay of these forces, reviews of aspects of a fund's operations may require freshening.

Over the last several years, the U.S. investment management industry has placed significant emphasis on compliance with laws, regulations, and rules. This has been driven, in large part, by the SEC's compliance program rules (for registered investment companies and investment advisers) adopted in 2003. Most observers believe the implementation of these rules has provided substantial benefits—and, importantly, identified areas of policies and practices that required updating. Most recently, SEC sweep examinations have had the effect of identifying additional areas of fund operations where management attention and directors' oversight should be increased.

Many oversight programs in place today—discharged by audit committees, internal auditors, compliance specialists, legal personnel, and risk managers incorporate sound risk assessment processes. Many of these processes embed the widely used risk concept of "likelihood and impact of errors or irregularities," appropriately take financial statement materiality into account, incorporate a factor directed at preserving business reputation, and utilize some form of rotational review. Understandably, many programs are also compelled to direct significant resources at "the public problem(s) of the day." Yet, oversight processes also need to keep in view areas of fund operations that may not be a current focus of public attention, or which have not been reviewed or evaluated recently with respect to the effectiveness of their internal control.

Suggested practices

- ***Assess which fund operations require review.*** Management might start 2007 with this question: "Regardless of materiality or any relationship to financial statements, what areas of a fund's operations have not been subject to some type of internal or external review in a while?"

- ***Compare disclosures to actual policies and practice.*** To enhance disclosures in public reports, it's important to periodically compare the disclosures and provisions contained in prospectuses and statements of additional information to actual policies and practices used or followed. This is particularly important in circumstances where there are multiple and/or third parties involved in a fund's operations and administrative services. Current control practices in this regard commonly emphasize the investment management and trading areas. However, there are others, such as shareholder transaction guidelines, where, generally, more focus may be beneficial.

- ***Ensure that contract provisions and actual compensation arrangements or practices are aligned.*** Oversight programs should include a focus on the alignment of contract provisions and actual compensation or fees paid to or received by funds, their service providers, subservice providers, and other agents, whether directly or indirectly. Contracts should describe the services performed for or on behalf of funds in sufficient detail to provide a basis for their approval and a means to determine that identical or overlapping services are not inadvertently part of more than one service contract and compensation arrangement. Confirmation should be obtained that all formal and informal compensatory arrangements between and among funds and their service providers, subservice providers, and any other agents have been disclosed to fund officers and directors.

- ***Review the manner in which money flows occur and are managed and controlled.*** In view of the significant level of money flow in and out of funds, and the ever-increasing number of intermediaries and service and subservice providers, management should take a fresh look at the manner in which these flows occur and are managed and controlled. Management should undertake current redeterminations to confirm or identify the parties benefiting from intraday and overnight dollar balances. These redeterminations should consider such information in the context of existing contractual provisions and parties' business intents and understandings. Provisions contained in fund prospectuses and statements of additional information covering the rights of purchasing and redeeming shareholders to share in the fund's capital gains and investment income should be mapped to actual transfer agent practices and checked for alignment with the timing of the availability of such monies to the fund for investment purposes.

- ***Review policies and procedures for managing the risk of theft or embezzlement.*** The industry's significant money flows, the "instantaneous movement" of funds, and the distributed nature of a fund's underwriting and transfer agent operations combine to increase the inherent and control risks of theft or embezzlement. The industry's favorable experience in this regard in recent years can lull it into a level of trustfulness that's negatively correlated with the potential risks at hand. Some organizations which have not looked at their policies and procedures in this area for some time may well benefit from a new review.

- ***Review year-end shareholder or partner tax reporting processes.*** From a tax perspective, year-end shareholder or partner tax reporting processes do not directly bear on financial reporting. Consequently, over time they may not be subject to as regular or thorough internal and external reviews as performed for other processes. Generally, the importance of these particular tax processes calls for more attention.

Conclusion

All told, the U.S. investment management industry continues on firm footing as it enters 2007, but faces worthy regulatory and operational challenges. Meeting those challenges will require a heightened focus on internal control, the structural foundation of the industry. In this report, PricewaterhouseCoopers has identified five areas of internal control and offered suggested practices to consider in each area. We believe these practices can help the industry to meet its significant challenges, operate more effectively in an increasingly complex environment, and strengthen investors' trust and confidence about the future of the industry.

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[1] Investment Company Institute: (1) Trends in Mutual Fund Investing (October 2006); and (2) Annual Survey of Mutual Fund Ownership and Use of the Internet (2006).

[2] Percentages derived from information presented in Investment Company Institute: Exchange-Traded Fund Assets, November 2006.

[3] Source: HFR Industry Reports, © HFR, Inc. Q4 2006, www.hedgefundresearch.com

Suggested Practices—Internal Control

1. Managing potential conflicts of interest
   - Embrace evaluation of conflicts of interest.
   - Develop objectives, dimensions and reporting protocols for a conflicts management process.
   - Implement a conflicts management process.
   - Identify parties with responsibility for relationships and activities that could create potential conflicts.
   - Use technology to help identify potential conflicts.
2. Overseeing third-party service arrangements
   - Focus on due diligence.
   - Establish oversight objectives.
   - Create a robust, clear process for managing third-party service providers.
   - Ensure that all parties understand their roles and responsibilities.
   - Monitor performance.
   - Ensure the nature of third-party reports is consistent with their intended use and that the period of testing is recent and of sufficient duration.
   - Use technology to confirm information integrity and identify anomalies.
3. Addressing the risks and reporting of complex investment strategies and financial instruments
   - Review current policies, practices and assumptions related to securities valuations.
   - Focus on broader business and internal control issues over valuations, beyond the accounting department.
   - Begin considering how to implement FAS 157.
   - Affirm expected degree of commonality of valuations, and understand any differences.
   - Apply more oversight when results are significantly influenced by subjective information.
   - Push some operations considerations forward to the front and middle offices.
   - Be aware that responsibility for valuation of alternative investments cannot be outsourced.
   - Prepare for rigorous auditing of fair value measurements.
   - Directors and trustees need to keep current with fair value developments.
4. Bringing more focus to tax matters
   - Evaluate the sufficiency of tax accounting and reporting resources of the sponsor and/or fund.
   - Develop FIN 48 implementation and sustainability plans.
   - Develop written policies and procedures encapsulating significant FIN 48 implementation challenges.
5. Staying alert to other potential risks
   - Assess which fund operations require review.
   - Compare disclosures to actual policies and practice.
   - Ensure that contract provisions and actual compensation arrangements or practices are aligned.
   - Review the manner in which money flows occur and are managed and controlled.
   - Review policies and procedures for managing the risk of theft or embezzlement.
   - Review year-end shareholder or partner tax reporting processes.

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