

December 31, 2010

*Current Developments
for Mutual Fund Audit
Committees*
Quarterly summary

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PwC survey finds broad differences in the way investment firms structure oversight of the portfolio valuation process

Asset management firms increasingly use valuation committees to oversee the pricing of securities and other portfolio holdings, but traditional and alternative managers take different approaches to building independence and external oversight into their governance structures, according to a benchmarking survey recently issued by PwC. The survey of more than 50 US based asset managers looked at the industry's biggest valuation challenges and risks, who is ultimately responsible for valuation and best practices in oversight of the valuation process.

Differences in governance structures

The survey responses revealed significant differences in governance structures across the asset management industry. Among the survey's key findings:

- Virtually all traditional fund respondents have a valuation committee. In most funds (74 percent), the committee oversees the valuation of all asset classes, not just illiquid or fair valued securities.
- While more than two-thirds of traditional fund respondents (68%) cited a lack of reliable data from pricing services as a key valuation risk, their boards have adopted two distinct approaches to managing this risk through oversight of pricing

vendors. Roughly half of the boards (48 percent) have direct or indirect oversight of vendors, while almost equal percentage (47 percent) have delegated this responsibility to management.

- Among alternative funds with no outside board, 60 percent have no enterprise or operational committee to oversee the valuation of investments. And three-quarters (75 percent) noted that the board has delegated complete oversight of vendor pricing services to management.
- Within the private equity and venture capital sector, 30 percent of respondents identified no oversight process beyond the valuation committee. The remaining 70 percent were split between boards, risk committees, limited partner (LP) advisory committees, or direct oversight from the partners of the general partnership.
- Within the real estate sector, half of respondents indicate that their firms have no enterprise or operational committee to oversee the valuation of investments.

One shared trait of the valuation committees at both traditional and alternative firms is the lack of independent representation:

- Only 21 percent of traditional investment firms and 16 percent of hedge funds, private equity firms and real estate managers have independent members on their committees.

- In fact, hedge funds are twice as likely to have traders, rather than independent members, sit on valuation committees.

Who is responsible for valuation?

A central finding of the benchmarking survey was the diversity of valuation governance structures across the industry. Valuation committees are the norm at traditional asset management firms where legal, compliance and fund administration or accounting officers were most heavily represented on these committees. Just over half (58%) relied on contributions from portfolio managers or analysts, and only 38 percent have a Chief Financial Officer sitting on the valuation committee.

Alternative investment firms, in contrast, rely heavily on the participation of finance executives and investment personnel. Nearly three quarters (74%) of hedge funds have the CFO, the executive most responsible for valuation at many firms, sit on the valuation committee.

Sixty percent of private equity firms indicate the CFO or an equivalent sits on the valuation committee, while approximately half or less have other finance staff and investment professionals participate. Only 20 percent of private equity firms have a Chief Compliance Officer participate on the valuation committee. At real estate funds, investment personnel comprise 88 percent of committees while 63 percent of committee members are acquisitions/underwriting professionals.

Key valuation challenges and risks

Reflecting higher volatility in the markets since the financial crisis began, an overwhelming majority of respondents cite market volatility and changing liquidity as the greatest valuation risks. Traditional asset management firms such as mutual funds (90%) and alternative investment firms

such hedge funds (81%) and real estate funds (75%) all cite this as their top risk. Private equity firms, which hold largely illiquid assets, are more concerned about selecting and obtaining appropriate market comparables, with 70 percent citing this as a top risk.

A reliance on portfolio managers and other internal investment professionals in estimating fair value was a common risk cited by survey respondents. Nearly two-thirds of real estate funds (63%), more than half (57%) of hedge funds and more than 40 percent of mutual funds citing this as a top concern. Valuations obtained from a single source or counterparty was also cited as risk by half (50%) of all hedge funds and more than four-in-ten (42%) mutual funds.

Rounding out the top valuation risks were the timely identification of significant events, cited by 60 percent of real estate managers and 42 percent of traditional asset managers, and the “reliability of data provided by outside pricing sources.” More than two-thirds (68%) of all traditional investment firms surveyed said this was area a key valuation risk, while just over one-third (38%) of alternative firms agreed.

Oversight of the pricing process

Pricing portfolio investments has long been among the most challenging responsibilities for firms, but the increasing complexity of securities coupled with growing market volatility and diminished transparency has radically complicated this essential task for valuation committees.

Less than half (47%) of traditional asset managers have an independent pricing verification (IPV) group in place to assist the valuation committee in pricing illiquid and difficult-to-price securities. Roughly half of traditional fund boards (48%) have direct or indirect oversight of their vendor pricing services and 47% have delegated complete oversight to management.

Nearly two-thirds (63%) of hedge funds and other alternative investment firms do not have an internal pricing group that is responsible for pricing illiquid or difficult-to-price securities. Among the firms that do, half of respondents indicated the pricing group reports to the CFO, and the other half stated it reports to the valuation committee.

Seventy percent of private equity firms do not use external valuation experts to value their portfolios. This is not an uncommon or unexpected, as many firms have the requisite resources internally to perform the valuations. Real estate funds, in contrast, rely heavily on external valuation experts as an independent resource to establish valuations, with 88 percent turning to these services for help.

Conclusion

In the wake of the credit crisis, there is a greater demand for increased transparency and disclosure about valuation practices and governance controls from across the spectrum of stakeholders. Pricing assets is more than a perfunctory task—the process itself can reflect an organization’s fundamental approach to risk management. Firms that overlook the need for unqualified independence, credibility and continuous improvement in this area do so at their own risk.

Furthermore, with the changing regulatory landscape, non-traditional asset management firms should consider adapting best practices to raise the effectiveness of their governance structures. Alternative investment firms may want to reconsider the composition, independence and expertise of their valuation committees in order to meet the heightened expectations of regulators, investors and counterparties.

While every firm has unique valuation challenges and issues, the process itself poses nearly as much risk to committees as externalities over which they have no control. Firms should carefully consider how they incorporate expertise into the process to avoid concentrations of risk in one method, person or source of data.

Finally, valuation approaches and governance structures are clearly evolving, and most firms have the basic building blocks of governance in place to meet new demands for transparency and accountability. Best practices will continue to evolve as the industry strives to achieve the same level of transparency in valuation that exists in other sectors.

The complete valuation survey is located at:

www.pwc.com/us/assetmanagement/valuation

Thoughts from the boardroom—A frank discussion

At our annual PwC Financial Services Audit Committee Forum, we played host to directors of major mutual fund boards for a roundtable discussion of their perspectives on risk management and the management contract review (15c) process. These topics are not new to board members; however, the discussion proved timely in light of the increased focus on risk management at many levels, including regulators, and, regarding contract review, the recent *Jones v. Harris Associates* ruling. The relaxed and frank discussion offered a window into board-level thinking.

Risk Management

The discussion on risk management focused on thoughts surrounding the definition of risk management, including the components of risk management, defining roles and board reporting.

Definition of risk management:

The discussion began with directors stating what they thought risk management means in their organization. Not surprisingly, a consensus was not reached on a definition of risk management and its components. Some board members noted the focus on their boards is still on the areas common to mutual funds such as valuation, investment policies, and counter-party awareness.

However, several board members noted they have taken a fresh perspective on risk management in their organizations to ensure they are capturing all potential risks. Some of the risks that were top-of-mind, given the current environment, included human capital risk—reflected in the skill set appropriate to role, uneven competency levels, and succession planning. Product development, sales practices, conflicts of interest, and regulatory concerns in the aftermath of a major economic crisis and reform effort also represented immediate concerns. One board member also noted that the board was focusing on insider trading, whistleblower policy and counterparties specifically for overnight investing. It became obvious throughout our discussions that directors clearly understood the importance of investment risk, and that it was the responsibility of the portfolio management organization to own that risk. Not surprising, this is an area that directors have and will continue to spend time discussing in light of its correlation with investment performance.

These differing views on the definition of risk management present challenges on the roles, responsibilities and requirements for directors and management.

Defining roles

The prevalent challenge faced by boards in all areas in assessing risk management is defining the boundaries

between oversight versus execution, or, in other words, what should management be doing and what should the board be doing? For instance, directors are asking themselves if there is a need for an individual (e.g., a chief risk officer) or committee who would take responsibility for internal deliberations on risk management.

Their answers differed. In some instances, the chief compliance officer (CCO) has general responsibility. One board has a separate chief investment risk officer. Many other participants said they do not have risk committees or chief risk officers, but rely on all levels of management and all staff to “own” risk management. In the absence of a single point of contact to interact with the board on risk management and oversee the risk management program, the directors acknowledged that there may be limitations on the content and quality of information provided to them on this topic.

Board reporting:

The directors then spent time sharing their perspectives on board reporting as it relates to risk management. Some directors stated that reporting focused on risk management information tended to be provided on an *ad hoc* basis in disparate presentations designed solely by management. Some board members questioned the inherent conflict in allowing management to have sole responsibility for such reporting without any collaboration or input from the directors.

Some noted that such reporting, without collaboration with the board, can often lack key elements, such as resolution of outstanding items, emerging issues the board should consider, and guidance concerning the completeness, timeliness, accuracy, or validity of the information. Participants said that in many cases, management presumed that the board “knew what to do” with the information it was provided, when in fact, board members

were unclear about the purpose and the relevance of the information reported, and, generally, the expectations management had of the board. Those directors that were provided with risk management metrics tended to focus more on quantitative measures than qualitative issues, relying more on the numbers and less on emerging issues not yet measurable.

One director indicated their board went so far as to organize a task force to assess the information provided by management to determine what critical information they really need. The outcome of this task force was to request fewer materials to review but in a more manageable and useful form (dashboards, heat maps, key indicators, etc.).

PwC point of view

The directors clearly had a great deal to discuss around risk management protocol, making it evident that this topic is now in the forefront of their minds. While there may not be one ‘agreed-upon’ definition of risk management, it is important for boards to assess, with the help of management, where the risks are in their organization. The areas of risk noted above may not apply to all organizations, but a key point to note is that risks will change and evolve as the economic and business environment changes; the concept of risk is clearly not static. Boards should have some method to assess if the risks they focus on are appropriate given the current environment and risk profile. In the context of mutual funds, it is easy to focus on risks solely within the funds themselves. However, the concept of enterprise-wide risk management is also critical and often times overlooked by boards and management. Enterprise-wide risk management contemplates all risks facing an organization—both domestically and internationally—and includes such items as strategic, operational and regulatory risks.

While individual risks are unique to any given organization, there is no

'one size fits all' model with regard to roles and responsibilities around risk management. Once the risks are identified for an organization, directors should assess whether they are receiving relevant and useful information about those risks, regardless of who reports on them or owns them. It is also important to periodically step back and make sure directors are maintaining their role as overseers and not stepping into the role of management. There's no roadmap to risk management. The most important objective for the director is to evaluate whether the advisor has prioritized the right level of emphasis on this topic and is striving for continuous improvement in the content and quality of the information provided.

15(c) contract review considerations including investment performance

The 15(c) process boards must perform is certainly one of the most important of their fiduciary duties. As a result, there is often little shortage of dialogue around the contract review process. The discussion focused on the impact of the *Jones v. Harris Associates* case, information reviewed and assessing fund performance.

Jones v. Harris:

In this case, the US Supreme Court tackled claims that a mutual fund advisor charged excessive fees. The court's decision essentially upheld the widely used requirements of a previous decision, known as the Gartenberg case. As a result of the ruling, directors seemed to think they were in general doing a bit more round the 15(c) process with a heightened level of focus on the Gartenberg standards.

With the sharper focus on the Gartenberg standards, the discussion easily moved into information reviewed during the contract review process.

Information reviewed:

Some boards have started to compare fees charged to the funds with those charged to separately managed accounts. Such an analysis may provide a good perspective on fees but it also requires sound business judgment to understand. There may be legitimate reasons the fee structure is different; management should clearly be able to articulate those reasons. The level of reporting to boards varied with some boards provided fees for all separately managed accounts while others were provided with a range of fees across investment strategies.

Some directors worried they are getting too much information concerning advisor performance and they may not really know what to do with it to make a meaningful decision. Some boards have outside consultants assist in the contract review process to help the directors analyze and assess the information provided. A common concern noted is that, when sub-advisors are used, most directors noted difficulty securing certain information from unaffiliated sub-advisors.

Fund performance:

Many firms, placing a premium on flexibility, do not implement hard performance targets that funds must meet. Yet, most directors long for a useful overarching analysis to make it simpler to understand which funds are outliers. Regardless of what analysis is done on different boards, many boards place funds with poor performance and high expense ratios on a watch list and establish fee waivers.

Fairly addressing performance and compensation in the context of the volatility of the past two years is currently a key element in the contract review process. It was noted that

striking a balance between patience and accountability could be quite subjective.

In the end, boards need to ensure they pay the right people enough to retain them and perform well. But they also worry that they are paying certain advisors more than their performance merits. One board represented on the roundtable employs an outside firm to assist with compensation review and to manage the balance.

PwC point of view

As with risk management, the 15(c) process should be fluid and adjusted as necessary for changes in the environment. As discussed, a challenge boards now face is assessing performance as the economy continues to emerge from the turmoil of the past two years. It is evident that the contract review process is challenging and time consuming given that it does not appear uncommon for boards to enlist the assistance of outside firms. Fund performance can be reviewed in numerous ways but it seems essential to have a plan for those funds that are not meeting some level of expected performance. The parameters do not have to be rigid and inflexible but some plan to monitor and ideally fix a poor performing fund should exist. Sometimes the contract review process focuses so heavily on the fund performance that it may be wise to step back and assess the advisor's compensation to determine if the skill set and compensation of the key players are commensurate with the fund performance.

Closing Thoughts

The discussion amongst the directors flowed easily around risk management and contract review. The process, roles, reporting and decisions surrounding both topics will likely not be the same across organizations. Consistency often emerged when the directors noted the challenges they faced with both topics. Directors all seem to be taking a hard look at how their boards handle these two areas to make sure they are doing what is appropriate for fund shareholders in the current environment and given the specific risks faced by the funds in their organization.

Regulatory developments

Insider trading and the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) dominated this quarter's regulatory landscape, but a federal district court also issued the first ruling concerning the *Gartenberg* standard after *Jones v. Harris Associates*, the seminal Supreme Court case addressing the advisory contract process that was issued earlier this year. This regulatory update summarizes this recent trial court decision, provides an update on the recent media spotlight on insider trading investigations, briefly discusses multiple rules proposed by the SEC to implement the Dodd-Frank Act, and highlights the recent announcement by the SEC's Office of Compliance Inspections and Examinations ("OCIE") that in appropriate cases it will seek to interview fund boards of directors as part of the examination process.

Gallus v. Ameriprise Financial Ruling

On December 8, 2010, a Minnesota federal district court judge issued the first opinion applying the Supreme Court's landmark mutual fund excessive fee case, *Jones v. Harris Associates*. In the decision, the federal district court reconsidered its 2007 ruling in favor of the defendant investment advisers in light of the Supreme Court's opinion in *Jones v. Harris Associates*. The district court concluded that in its 2007 grant of summary judgement it had properly applied the *Gartenberg* "framework and reasoning" that the Supreme Court had endorsed in *Jones v. Harris Associates*. As a result, the federal district court

concluded, "nothing remains for this Court to decide," and the court reinstated its prior dismissal of the case. The opinion appears implicitly to reject the argument that plaintiffs in excessive fee cases can establish liability under Section 36(b) of the Investment Company Act of 1940 outside of the scope of the *Gartenberg* analysis.

The *Gallus* case has a long history. Shareholders had sued the defendant investment adviser, accusing it of charging excessive fees in violation of its fiduciary duty. Citing the *Gartenberg* case, the district court granted defendants summary judgment in 2007, concluding that there was no material issue of disputed fact as to whether "the fees charged were so disproportionate that they bear no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." The Eighth Circuit Court of Appeals reversed the 2007 decision, ruling that the district court had correctly applied *Gartenberg*, but suggesting that there might be other means by which an adviser might violate its fiduciary duty in excessive fee cases. After the *Jones v. Harris Associates* decision, the Supreme Court sent the *Gallus* case back to the Eighth Circuit for reconsideration, which in turn sent it back to the district court.

The decision reinforces that complying with the *Gartenberg* standard will tend to protect investment advisers and, by extension, fund boards from private liability under Section 36(b) in excessive fee cases.

Insider Trading and “Expert Networks”

On November 20, a front-page headline in the *Wall Street Journal* first reported the existence of investigations by the SEC and the Department of Justice into insider trading by asset management firms. According to the Journal’s report, and follow-on coverage in subsequent days, the probe focuses on the use of “expert-network” research consultants that provide asset managers with insights into various industries, including but not limited to technology, healthcare, and retail. These “experts” often have held positions with or have contacts in some of the issuers about which they provide information. In some cases, experts have consisted of physicians who are involved in clinical trials of new drugs and treatment regimens. The *Journal*’s coverage focused on a particular “expert-network” provider in California, who said he was approached in late October by two FBI agents seeking to get him to wear a wire and secretly record conversations with certain asset management firms.

On November 22, FBI agents executed search warrants on asset management firms in New York, Connecticut, and Massachusetts. Multiple asset managers -- including at least two traditional asset managers -- received a fax subpoena from an Assistant United States Attorney (“AUSA”) in the Southern District of New York (“SDNY”). The subpoenae were largely identical and appeared to focus on trading in technology stocks and the use of expert networks. On November 24, an employee of an expert network firm was arrested and charged with conspiracy to violate the federal securities laws. Additional arrests occurred on December 15.

While these headlines are prominent, the focus on insider trading is not new. The SEC’s Division of Enforcement announced a “Market Abuse” specialized unit in 2009 whose mandate is insider trading cases involving repeat

(rather than one-off) instances of insider trading. Moreover, as recently as November 2, the SEC brought insider trading charges against a French doctor (who was associated with an expert-network consultant) who stands accused of providing material non-public information about certain clinical trials in which he was involved to a New York-based hedge fund that subsequently traded in the securities of the issuer conducting the trials. The SEC also continues to announce charges stemming out of major insider trading cases (such as the December 2009 case involving asset manager Galleon Group), including a case filed on November 15, 2010, against a hedge fund and others. The US Attorney for the SDNY and the Director of the SEC’s Enforcement Division have repeatedly and publicly denounced what they call “rampant” insider trading in the asset management industry and have vowed to bring insider traders to justice.

These insider trading cases involving “expert networks” are only one subset of numerous investigations; nearly every week, the SEC files additional insider trading cases. In light of these enforcement efforts, mutual fund boards might be well-served to ask questions concerning the management company’s exposure to such networks, steps that have been taken to identify sources of material nonpublic information and address the risks, and the overall program for addressing misuse of material nonpublic information. In some cases, where the risk is acute, boards might consider hiring third parties to review existing training, controls and surveillance addressed to insider trading to ensure that appropriate standards are being met.

SEC/CFTC rulemaking implementing Financial Reform Legislation

In the last quarter of 2010, the SEC and Commodity Futures Trading Commission (“CFTC”) have issued multiple proposed rules implementing the provisions of the Dodd-Frank Act. Among the highlights of the SEC’s proposed rules are the following:

- Proposed rules setting forth the exemptions available to investment advisers that might otherwise have to register with the SEC, such as advisers solely to venture capital funds;
- Proposed rules increasing the amount of disclosure required in Form ADV, including information regarding private funds, business operations, types of clients, employees, advisory activities, conflicts of interest (i.e., use of affiliated brokers, soft dollar arrangements and compensation for client referrals), and non-advisory activities, including their financial industry affiliations.
- Proposed rules implementing the Dodd-Frank “whistleblower” provision that permits the payment of bounties to persons who provide the SEC with original information about federal securities laws violations.

The SEC and CFTC have also issued rules defining some of the key terms and scope of the swaps reform required under Dodd-Frank. In particular, the agencies defined the term “major swaps participant.” While members of the CFTC have orally expressed the view that few entities would be deemed a “major swaps participant,” it remains to be seen what entities will be so designated under the proposed definitions and therefore subject to additional regulatory burdens and oversight.

The proposed rules are all subject to public comment, though the comment periods are relatively short. The agencies expect to finalize the rules in spring of 2011.

OCIE to interview board members in connection with exams

Carlo DiFlorio, the director of OCIE, announced in a recent speech and subsequent interview that SEC examinations may involve inquiries to and interviews of mutual fund board directors. DiFlorio said that boards would only hear from examiners after the firm had been selected for examination and only in cases where there were significant concerns. Contacting directors is new to OCIE and is said to be part of OCIE’s focus on broader compliance and governance issues. According to news reports, boards will also be given a copy of the OCIE exam team’s report (in addition to senior management and the CCO).

As expected, the third quarter of 2010 was bustling with regulatory matters. The developments discussed highlight the need to certainly stay abreast of current developments as they are often wide-spread and far reaching. The *Gallus v. Ameriprise* ruling is a win for the industry in a time when asset managers are facing increasing scrutiny. As we head into 2011, the focus will certainly be on the implementation and rule making surrounding Dodd-Frank.

Tax developments

A first look at the Regulated Investment Company Modernization Act of 2010

The Regulated Investment Company Modernization Act of 2010 (the “Act”) was signed by President Obama on December 22, 2010. The Act is an exciting milestone for the mutual fund industry and will provide significant benefits to RICs and RIC stakeholders. PwC has been strongly supportive of the mutual fund industry’s development and pursuit of this legislation.

The Act represents the culmination of the mutual fund industry’s efforts in recent years to modernize various tax rules applicable to regulated investment companies (“RICs” or “funds”). The Act contains 17 provisions that, collectively, are among the most significant to affect RICs since the Tax Reform Act of 1986.

Two key changes were made to the Act since it was first introduced in the House of Representatives a year ago.

- A provision to eliminate one of the current restrictions on a RIC’s ability to directly invest in commodities was dropped after several Senators expressed concerns about its potential impact on the commodities markets. The provision would have also reduced uncertainty faced by RICs with foreign currency investment objectives about the qualifying nature of certain foreign currency gains. It is unclear whether this provision will be re-proposed

at a later time. RICs can continue to gain exposure to commodities through properly structured offshore blocker corporations and certain commodity derivatives.

- A revenue raising provision, effective in 2011, was inserted to increase a RIC’s required capital gain distribution to avoid excise tax from 98 percent to 98.2 percent. Practically, this change may have a limited impact on the excise distribution process of RICs as many funds currently seek to distribute 100 percent of their excise basis capital gains to shareholders. The annual required distribution for ordinary income remains unchanged at 98 percent. This provision turned the Act from a small revenue loser into a revenue raiser.

Key questions to consider as the Act becomes effective

How will the Act impact RIC tax risk?

Today RICs face numerous potentially severe tax consequences for inadvertent compliance oversights or errors. The Act modifies certain of these rules reducing the tax risks faced by RICs.

For example, the Act will allow RICs to pay financial penalties rather than lose RIC tax status for qualification violations. It is critical to note that relief will be at the discretion of the IRS upon the RIC showing that the failure was due to reasonable cause and not neglect.

Changes to other rules—such as the cost associated with paying dividends

late, certain requirements related to spillover dividends, and RIC dividend designation requirements—will narrow the circumstances in which a RIC could face severe tax consequences due to an inadvertent rule violation. The Act also eliminates the preferential dividend rule for most RICs. Under this rule, minor errors in RIC dividends paid between shareholders or classes potentially jeopardize a fund's entire dividend paid deduction.

In the near-term, implementation of the Act's provisions may increase tax risk in other areas. For example, the Act changes the character of a RIC's capital loss carryovers and contains a complex transition rule. This provision increases tax calculation risk. The transition rules also pose risk, especially for fund complexes with multiple year ends as both rules will be in effect concurrently for different funds.

What effect does the Act have on a RIC's tax controls?

Even though the Act reduces some tax risks, RICs will still need strong controls over tax matters to avoid the severe tax consequences that can still result from rule violations. These consequences will remain costly from a monetary and reputational perspective. Accordingly, a RIC's management will still need to control tax risks in areas such as RIC qualification, calculation of taxable income, and information reporting.

What opportunities does the Act present?

Even though product design opportunities were lost when the commodity provision was dropped, the Act presents other prospects for mutual fund product or strategy innovation.

- RIC fund of funds—RIC fund of funds will now be able to own international funds and municipal bond funds and pass-through foreign tax credits and tax-exempt income from those funds to fund of funds shareholders. This change may lead to the development of new municipal bond and

internationally focused RIC fund of funds products or modifications to existing investment strategies.

- Fund distribution—The repeal of the preferential dividend rule may allow advisers to seek fee arrangements they were previously restricted from pursuing.
- Tax efficiency—Advisers that seek to differentiate their funds on a tax efficiency basis will need to carefully evaluate how changes to the capital loss carryover provisions affect this objective.

Who needs to understand the changes made by the Act?

A broad range of groups providing services to a RIC will see some aspect of their responsibilities affected by the Act. Beyond a RIC's management and its tax service providers, personnel in the fund reporting, marketing, transfer agency, information technology and compliance functions will need to understand how the Act affects their duties. In addition, individuals responsible for product development may also benefit from understanding the Act's provisions. Management may want to consider assembling a task force to analyze the Act and assess its impact on a RIC's various service providers.

How soon can a RIC take advantage of the changes made by the Act?

The Act's provisions are generally effective for RIC tax years beginning after the date of enactment. Because the Act's effective dates are based on a RIC's tax year, management will not be able to adopt the Act's changes on a complex wide basis if the funds have different tax year ends. It is critical that management not adopt the Act's changes too soon as qualification issues could result.

A RIC's management should consider how and whether state and local jurisdictions update their tax laws to conform to federal tax law changes. The fact that some states do not automatically conform to the federal

law could create unexpected tax consequences as the Act's changes are implemented.

For example, assume a state allows RICs to claim a deduction for dividends paid. Based on the law change, a RIC utilizes the asset diversification test savings provision to avoid a RIC disqualification. If a state in which the RIC is subject to tax does not conform to the federal savings provision change (i.e., the state uses the old federal definition of a RIC) the fund may fail to meet the definition of a RIC for state tax purposes thereby jeopardizing its ability to claim the dividends paid deduction.

The Act: summary of key provisions and observations

Modification of the RIC capital loss carryover rules

Current law

A RIC is allowed to carryover a capital loss to the next eight taxable years. A loss is carried over to a subsequent tax year as a short-term capital loss regardless of whether it was initially realized as a long-term capital loss. To the extent a capital loss carryover is not utilized by a RIC within the eight year period, the losses expire and may no longer be used.

New law

The Act makes significant changes to the capital loss carryover rules for RICs that are effective for taxable years beginning after the date of enactment. These changes include:

- An elimination of the eight year carryover period. The Act will allow a RIC to carryover capital losses for an unlimited period of time (i.e., the losses never expire).
- A capital loss will now be carried

over to a subsequent tax year in the character realized. The rules will apply as follows:

- If a RIC's net short-term capital loss exceeds its net long-term capital gain at the end of a tax year, the excess will be treated as a short-term capital loss on the first day of the RIC's next tax year.
- If a RIC's net long-term capital loss exceeds its net short-term capital gain at the end of a tax year, the excess will be treated as a long-term capital loss on the first day of the RIC's next tax year.
- A capital loss carryover is treated as arising on the first day of the tax year to which the losses are carried for purposes of calculating a RIC's taxable income and its current and accumulated earning and profits.
- The Act provides a transition rule for capital loss carryovers that arose in tax years beginning before the date of enactment. Under this rule, capital loss carryovers generated in tax years beginning after enactment must be fully used before capital loss carryovers generated in tax years beginning before enactment.

The transition rule is illustrated by the following example:

A calendar year end RIC generates a \$100 million net capital loss in 2008 and none of this capital loss carryover is used as of December 31, 2010. This capital loss carryover will expire as of December 31, 2016. During 2011, the first tax year to which the Act applies, the RIC generates a \$300 million capital loss. The RIC will not be able to utilize any of the \$100 million capital loss carryover generated during the tax year ended December 31, 2008 until the \$300 million capital loss carryover from 2011 is utilized.

PwC insights

- A RIC's tax efficiency will be affected by these changes. The elimination of the eight year carryover period improves tax efficiency. On the other hand, the change to carryover losses in the character realized will, in some situations, decrease the tax efficiency of a RIC as compared to current law.

For example, assume in Year 1 a RIC has a \$500 long-term capital loss and in Year 2 the RIC has a \$500 short-term capital gain and a \$500 long-term capital gain.

- Under current law the RIC would have a \$500 long-term capital gain in year 2 after the carryover of the year 1 loss (i.e., the year 1 loss is carried over to year 2 as a short-term capital loss offsetting the short-term capital gain first).
- Under the new law the RIC would have a \$500 short-term capital gain in year 2 after the carryover of the year 1 loss (i.e., the year 1 loss is carried over to year 2 as a long-term capital loss offsetting the long-term capital gain first).

Given the large difference that currently exists between the tax rates applicable to individuals on short-term capital gains and long-term capital gains this change is significant. Management may want to consider whether these rules affect a RIC's tax planning.

- Depending on future market conditions, the transition rule could result in a substantial portion of a RIC's pre-effective date capital losses expiring unused.
- RICs must separately track capital loss carryovers for purposes of calculating fiscal and excise distribution requirements. The Act does not change this. Separate

application of the new carryover rules and transition rule for fiscal and excise purposes may result in coordination challenges.

- For RICs that claim a dividends paid deduction with respect to redemption payments, management will need to assess how the changes to the treatment of capital loss carryovers for earnings and profits purposes will impact the calculation of these amounts.
- These changes may pose questions and challenges about how the various loss limitation rules (e.g., Internal Revenue Code Sections 381, 382, and 384) will be applied in situations where a merger or other ownership change has occurred. In addition, to accurately apply any loss limitations, tax service providers will still need to keep detailed records of the tax year in which a capital loss carryover originated.
- As noted earlier, these changes will require careful implementation and tight controls over tax calculations to avoid risk of improper distribution amounts or character. These changes will require tax service providers to develop new policies and procedures and update and test revised taxable income calculation templates for both fiscal and excise purposes. Financial statement disclosures of capital loss carryovers will also need to be modified.

While the changes are conceptually straightforward, we anticipate that challenges will arise as the rules are applied in practice. Since, in most cases, the changes won't apply for at least a year, tax service providers should have sufficient time to implement the necessary changes.

Remedies for failures to satisfy RIC gross income and asset diversification tests

Current law

There is no remedy for a failure of the RIC gross income test and only limited remedies for a failure of the RIC asset diversification tests. If a fund fails one of these qualification tests it loses its status as a RIC and is taxed as a corporation. It will also lose the ability to flow through tax attributes to fund shareholders.

For example, a large fund with \$1 billion of income and gains could face a federal income tax liability of \$350 million if its RIC status is lost due to a failure of an asset diversification test or the gross income test, even if the failure is de minimis or inadvertent. If the fund is a municipal bond fund, shareholders would be taxed on purported tax-exempt dividends.

New law

The Act provides new remedies for funds to address inadvertent failures of the RIC qualification tests. The provisions are intended to save a RIC from the draconian consequences of disqualification but yet impose a meaningful penalty for non-compliance. In general, the savings provisions for inadvertent failures allow a fund to preserve its RIC status even though it failed a qualification test so long as the fund follows prescribed rules and pays a deductible tax.

The Act also provides a remedy for de minimis failures of the RIC asset diversification tests. This provision only requires a correction of the failure within a prescribed period of time with no penalty imposed.

The qualification test remedies extended to RICs under the Act are substantially similar to remedies that were previously made available to real estate investment trusts (REITs). These provisions apply

to RIC tax years with respect to which the due date (determined with regard to extensions) of the tax return is after the date of enactment (i.e., the remedies are available to RICs with a tax year ended on or after April 30, 2010).

PwC insights

- These changes provide a mutual fund with an alternative to the significant consequences of RIC disqualification. While the changes provide a helpful alternative, the calculation of tax for inadvertent failures may be complex and subject to interpretation.
- The threshold for applying the de minimis provision is quite low and one can reasonably expect that it will be applicable only in very limited situations.
- A RIC that intends to use the savings provision for an inadvertent failure must demonstrate that the failure was due to reasonable cause and not willful neglect. To establish a failure is due to reasonable cause, a RIC will need to show that strong controls exist over the asset diversification or gross income test process. Thus, management may choose to assess the strength of their qualification test procedures and policies so they could feel comfortable asserting that any inadvertent error would not be the result of willful neglect.

Modification of rules related to dividends and other distributions

Coordination between excise and fiscal distribution rules

Current law

A RIC must comply with two sets of rules that govern the timing and amount of distributions paid to its shareholders. The excise distribution rules are applied on a calendar year basis and the fiscal distribution rules are applied on the basis of a RIC's tax year.

Rules exist under current law to coordinate the two distribution regimes. The coordination is primarily accomplished through rules that preserve distributions made for excise tax purposes by allowing certain subsequent losses to be deferred for purposes of calculating a RIC's fiscal distribution requirements.

However, in certain situations the existing coordination rules are inadequate. For example, the rules do not allow certain post-excise losses to be deferred. This may cause a RIC to treat the excise distribution as a return of capital and subject the RIC to excise tax.

New law

The Act makes substantial changes to the existing rules that are intended to improve the coordination between the excise and fiscal distribution regimes by:

- Modifying existing rules that allow deferral of certain post-excise capital losses, foreign currency losses, and passive foreign investment company (PFIC) losses for fiscal distribution purposes,
- Permitting the deferral of certain ordinary losses for both fiscal and excise distribution purposes, and
- Cutting off at October 31, for excise distribution purposes, recognition of ordinary gains or losses that result from the mark-to-market, sale, exchange, or other disposition of property.

Changes to the excise distribution rules will take effect in 2011. The other changes will apply to taxable years beginning after the date of enactment.

PwC insights

- The changes will significantly improve coordination between the two distribution requirements eliminating problems that arise under current law.
- Current regulatory guidance addressing excise and fiscal coordination issues will likely need to be revisited in light of the Act's changes.
- Similar to the changes to the capital loss carryover rules, these changes will also require careful implementation and tight controls over tax calculations to avoid risk of improper distribution amounts or character. New policies and procedures will need to be developed, tested, and implemented to guide tax personnel through the decisions of which losses should be deferred. Reconciliations between fiscal and excise distribution calculations will be an important part of these procedures. In addition new calculation templates will need to be developed to calculate the allowable loss deferral amounts for the fiscal and excise distribution calculations.

While the changes are conceptually straightforward, we anticipate that challenges will arise as the rules are applied in practice. Tax service providers should have sufficient time to prepare for these changes, since it will be nearly a year before the new rules are effective for most funds.

- While these changes will help better coordinate the excise and fiscal distribution regimes going forward, it does not provide a remedy for cumulative differences that may currently exist between a RIC's excise and fiscal distribution requirements. A RIC with such differences will need to continue to annually assess their effect on the distribution requirements.

- RICs will be able to improve the accuracy of their excise distributions because of the change that will allow a RIC to cut-off, at October 31, recognition of ordinary gains or losses that result from the mark-to-market, sale, exchange, or other disposition of property. Currently RICs face operational challenges in accurately estimating income or loss from these sources within the calendar year period.

Repeal of the preferential dividend rule for publicly offered RICs

Current law

The preferential dividend rule seeks to ensure dividends are distributed to shareholders on a pro-rata basis. If a RIC pays a preferential (i.e., not pro-rata) dividend, the fund is unable to claim a dividends paid deduction with respect to the distribution, and potentially for all dividends paid for the year. This rule poses significant tax risk especially for RICs with multiple class structures or RICs that are an investment option for a wrap account. To avoid the harsh tax result, dividends for multiple class funds are carefully calculated to ensure distributions only differ by allowable class-specific expenses.

New law

The Act repeals the preferential dividend rule for publicly offered RICs. Congress concluded the rule is unnecessary for these funds due to the investor protection provisions in securities laws. This change is effective for distributions in taxable years beginning after the date of enactment.

PwC insights

- After this change it will be even more important for a RIC's management to monitor the fund's status as a publicly offered RIC, as defined in the Internal Revenue Code.
- Most RICs with multiple classes of stock will no longer face the tax risks associated with a preferential dividend error.

- Wrap providers will no longer face tax restrictions on the fee arrangements that can be established when publicly offered RICs are held in a wrap account.

Pass-through of exempt-interest dividends and foreign tax credits in RIC fund of funds structures

Current law

RICs must meet an asset threshold to pass through tax-exempt interest and foreign tax credits. A RIC fund of funds cannot meet these requirements. As a result, there are no municipal bond RIC fund of funds. RICs investing in internationally focused funds cannot pass through the foreign tax credit.

New law

The Act will allow a RIC fund of funds to pass through these items to the extent it is a qualified fund of funds. A RIC will be a qualified fund of funds if, at the end of each quarter of the taxable year, at least 50 percent of the value of its total assets is represented by interests in other RICs. This provision is effective for taxable years beginning after the date of enactment.

PwC insights

- The change may allow fund advisers to structure municipal bond RIC fund of funds. Advisers may also increase the tax efficiency of other RIC fund of funds by flowing through foreign tax credits.
- The management of a RIC seeking to use this provision will need to establish procedures to monitor its status as a qualified fund of funds.

Elimination of certain arcane requirements of the RIC spillover dividend rules

Current law

RICs eliminate their taxable income via a dividends paid deduction. The “spillover” dividend election allows a RIC to eliminate income and gains earned in a year via certain dividends paid to shareholders during the next year. A dividend can only be treated as a spillover dividend if a RIC adheres to rigid statutory requirements that specify when the dividend must be declared (by the tax return due date) and paid (not later than the fund’s next regular dividend after it is declared). A failure to satisfy these requirements (e.g., a tax return extension is missed and the spillover dividend is not declared) can result in a failed spillover election and subject a fund to income tax on the related income.

New law

The Act makes two changes that are intended to prevent RICs from inadvertently failing to satisfy the spillover dividend rules. First, the Act eliminates the likelihood that a late filed income tax return extension could result in a failed spillover election. Second, the Act modifies the “next regular dividend” rule. These changes are effective for distributions in taxable years beginning after the date of enactment.

PwC insights

- Many RICs prefer to pay gain distributions once per year. In order to avoid the missed extension issue described above, they declare dividends by the unextended tax return due date. The next regular dividend rule then requires monthly and quarterly income paying funds to pay gains with the next income dividend. The Act eliminates the need for the extra gain dividend allowing the spillback to be paid with the next dividend of the same character (e.g., short- or long-term

gain). That said, some RICs prefer to pay spillback dividends shortly after their fiscal year end to more closely align the shareholders receiving the dividend with those in the RIC when the income is earned.

- Even though a missed income tax return extension will no longer result in a fund’s failed spillback election, management will still need to maintain strong controls over this process. A timely filed extension is necessary for other elections made on a tax return. In the case of a missed extension, obtaining relief for those elections remains at the discretion of the IRS and may be costly.

Modification of the various RIC dividend designation rules

Current law

RICs are allowed to flow through many tax attributes to shareholders (e.g., long-term capital gains, foreign tax credits). To do so, a RIC must comply with specific designation requirements. A failure to timely or accurately designate a dividend can result in significant consequences for fund shareholders as the beneficial attribute does not flow through. The failure can also cause liabilities for a RIC including tax for failure to designate capital gain dividends or information reporting penalties for issuing erroneous Forms 1099-DIV or failing to sufficiently withhold tax on a non-resident.

New law

The Act makes changes that are intended to significantly reduce the circumstances under which a RIC dividend designation failure may occur.

- First, the Act eliminates the current annual deadline by which dividend designations must be made (i.e., the 60-day notice requirement). This change provides RICs with unlimited flexibility as to when such designations are made.

- Second, RICs are afforded additional flexibility as to what constitutes an acceptable designation as the Joint Committee on Taxation's technical explanation of the Act suggests the designation requirements can be satisfied through Form 1099 reporting.

The Act also adopts new rules to improve the coordination between the dividend designation provisions and the annual information reporting to shareholders. These rules are intended to reduce the need for amended Forms 1099-DIV in certain situations.

These changes are effective for taxable years beginning after the date of enactment.

PwC insights

- The dividend designation rules were adopted before the information reporting rules and have long been viewed as unnecessary and adding unwanted tax risk.
- The new law provides RICs with substantial flexibility in the time and manner in which dividend designations are made.
- Management should assess how the changes will affect their funds' designation practices. Most RICs have historically made their dividend designations in the unaudited section of their annual financial statements. That said, the basis on which shareholders file their returns is from Forms 1099 and related shareholder tax information letters.
- Notably, the Act does not specifically address whether a dividend designation that was published electronically (e.g., a website posting) would be acceptable.

Modification of rules related to the characterization of a redemption of RIC stock

Current law

General corporate tax rules require analysis of stock redemptions to determine whether they should be treated as dividends or sales of shares. These long-standing anti-abuse rules are designed to prevent substantial stockholders from taxing redemptions at capital gain rather than ordinary income tax rates.

These rules can cause uncertainty for RICs about the amount of dividends paid, which can affect the financial reporting and information reporting of the RIC's dividends as well as its compliance with the RIC distribution requirements. It is impractical to test an open-end RIC's daily redemptions under these rules. Accordingly, open-end RICs have historically presumed that redemptions of their shares are characterized as a sale or exchange of the stock. In situations where a shareholder owns a substantial portion of a RIC, for example a RIC fund of funds or an insurance company separate account, this characterization may be less clear.

New law

The Act clarifies that a redemption of stock from a publicly offered RIC is treated as a sale of shares (i.e., not a dividend) so long as the redemption is on the demand of the shareholder and the RIC issues only stock that is redeemable on the demand of the shareholder. This provision is effective for distributions after the date of enactment.

PwC insights

- This clarification preserves the historic characterizations of redemptions from open-end RICs and eliminates uncertainty in more complex situations.

- Similar to the preferential dividend rule, the relief afforded by this change is limited only to publicly offered RICs. As mentioned earlier, monitoring a fund's status as a publicly offered RIC has new importance.

Modification of related party deferral rules for RIC fund of funds

Current law

Another general corporate tax rule that causes uncertainty for RICs requires deferral of losses on share redemptions if a corporation owns a substantial portion of another corporation (i.e., the related party loss deferral rules). In situations where a RIC fund of funds owns a substantial portion of a lower tier fund, these rules may prevent the RIC from recognizing losses on redemptions from the lower tier fund.

New law

The Act modifies the related party loss deferral rules to exclude a RIC fund of funds, so long as the redemption is on the demand of the fund of funds and the lower tier fund issues only stock that is redeemable on the demand of the shareholder. This provision is effective for distributions after the date of enactment.

PwC insights

- This change eliminates the potential for significant loss deferrals by a RIC fund of funds. Under current law, these deferrals can cause a fund to make distributions to shareholders even if substantial economic losses were realized during the year.
- This change is effective immediately. A fund of funds with a calendar year end will need to consider this rule change when calculating its fiscal distribution requirements for 2010.
- RIC fund of funds that have deferred such losses prior to the Act will need to assess the implications of this change on previously deferred losses.

Other provisions

Repeal of the assessable penalty component of the deficiency dividend provision

Current law

A RIC may find that, after filing its federal income tax return, it failed to fully distribute all of its taxable income with respect to that tax year. A shortfall may arise for many reasons including the discovery of a tax calculation error or because new information has come to light that affects the taxable income of the RIC. In these situations, a RIC can still pay a dividend to eliminate the taxable income through the deficiency dividend procedures as an alternative to paying tax on its distribution shortfall.

Under current law, a RIC utilizing the deficiency dividend procedures must pay both an interest charge, calculated with respect to the amount of the deficiency dividend (not the interest on the tax liability associated with the dividend), and a penalty equal to the lesser of the interest charge or one-half of the amount of the deficiency dividend. Collectively, these amounts represent the "cost" of utilizing the deficiency dividend procedures. The benefits a RIC and its shareholders can receive through the dividend deficiency provisions can be diminished by these costs, which can be substantial.

New law

The Act repeals the penalty, conforming the treatment of RICs to REITs under the deficiency dividend rules. This provision applies to taxable years beginning after the date of enactment.

PwC insights

- The deficiency dividend procedure is rarely used due to the high interest and penalty charges and because the RIC must still pay the dividend. This change reduces the costs a RIC and its shareholders face when using the deficiency dividend procedures.

While the reduced costs will enhance the attractiveness of using the deficiency dividend procedures in certain situations, it remains an expensive because the interest charge is calculated on the amount of the dividend not the hypothetical tax.

Other changes made by the Act

The Act makes several other changes to the RIC rules. These changes will:

- Eliminate certain situations under current law where RIC shareholders are penalized because an economic return of capital distribution is treated as a taxable dividend.
- Reduce the circumstances under which a RIC with a fiscal year end must amend Forms 1099-DIV to report a return of capital distribution paid to its shareholders.
- Clarify that a RIC's exemption from complying with the excise distribution requirements is not jeopardized because its shares are owned by a RIC fund of funds that itself is exempt from the excise distribution requirements.
- Clarify other arcane rules that may affect a RIC's calculation of its excise tax liability.
- Modify minor rules that may affect a shareholder's tax accounting of his/her transactions with a RIC.

PwC insights

- Under current law, non-calendar year end RICs can face challenges coordinating the characterization of distributions for fiscal and Form 1099 reporting purposes. The Act resolves some of these challenges. In general, these provisions will be effective for calendar year 2011 Form 1099 reporting.

For more information on the material presented here, please feel free to contact your PwC representative, or the tax partners listed at the end of this publication.

Summary of developments for the six months ended December 31, 2010

Accounting and financial reporting matters from the FASB, PCAOB, SEC, and others

On December 3, 2010, the SEC voted unanimously to propose joint rules with the Commodity Futures Trading Commission (CFTC) that would further define a series of terms related to the security-based swaps market, including “swap dealer,” “security-based swap dealer,” “major swap participant,” “major security-based swap participant” and “eligible contract participant.” The joint proposal of the SEC and the CFTC in part would add new rules under the Securities Exchange Act of 1934. The rules seek to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which among other things established a comprehensive framework for regulating the over-the counter swaps market. The SEC will seek public comment on the proposed rules for a period of 60 days following their publication in the Federal Register.

On November 10, 2010, the FASB (the “Board”) discussed the redeliberation plan for its loss contingencies disclosure project (the “proposal”). The FASB staff summarized the feedback provided by respondents in the comment letter process. Many respondents recommended that the existing standard be retained and that the proposal not be

finalized. The Board discussed whether the concerns raised by investors result from a compliance or standard-setting issue. Prior to concluding on whether an amendment to the existing standard is still needed, the Board decided to evaluate whether there is improved disclosure of loss contingencies during the 2010 year-end financial reporting cycle. At that time, the Board will decide whether any future redeliberations are needed or whether additional outreach on the proposal should be made. This decision effectively delays the project until the second quarter of 2011 at the earliest, and most likely until the second half of 2011.

On November 3, 2010, the FASB released its proposed Accounting Standard Update (ASU) Transfers and Servicing (Topic 860), Reconsideration of Effective Control for Repurchase Agreements. The main objective is to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The proposal would no longer require the transferor to consider whether sufficient collateral has been exchanged to reasonably assure the arrangement’s compilation (i.e., that substantially all of the transferred assets can be reacquired), even in the event of default. The amendments in this proposed update would apply to all

entities, both public and nonpublic. The amendments would affect all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The amendments would not affect other transfers of financial assets. The amendments would be effective for new transfers and existing transactions that are modified as of the beginning of the first interim or annual period after the final update's issuance. The final update is expected to be issued during the first quarter of 2011. Comments were due by January 15, 2011.

On September 10, 2010, the SEC approved expansion of a recently-adopted circuit breaker program to include stocks in the Russell 1000 Index and over 300 exchange-traded funds. Trading in a stock would pause across U.S. equity markets for a five-minute period should the stock experience a 10 percent change over the prior five minutes. The pilot program will run until December 10, 2010.

On June 29, 2010, the FASB released its proposed Accounting Standards Update (ASU) Fair Value Measurements and Disclosures (Topic 820) – Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS. Many of the proposed changes are wording changes or clarifications of the FASB's intent about how existing fair value measurement and disclosure guidance should be applied. The changes are intended to drive consistent application of the principles between U.S. GAAP and IFRS. Although many of the changes are not expected to have a significant effect on existing practice, the FASB has also proposed some amendments that would change fair value principles and disclosure. Most notably, the proposals would prohibit the use of "blockage" factors in the valuation of all investments, not just those classified as "Level 1" (i.e., those that trade in active

markets), and would require disclosure of "measurement uncertainty" in valuations, which is similar in many respects to the proposed "sensitivity analysis" disclosure which ultimately was not adopted by FASB in 2009. The proposal will affect all entities that measure assets, liabilities or equity at fair value. The FASB will determine the effective date after considering feedback on the exposure draft. Comments were due by September 7, 2010.

Auditing matters from the PCAOB, AICPA, and SEC

On August 5, 2010, the PCAOB adopted eight auditing standards related to the auditor's assessment of and response to risk that will supersede six of the Board's interim auditing standards and related amendments. The revised auditing standards will be applicable to all registered firms conducting audits in accordance with PCAOB standards. This benefits investors by establishing requirements that enhance the effectiveness of the auditor's assessment of and response to the risks of material misstatement in an audit. Specifically, the Board adopted the following standards:

- Auditing Standard No. 8, *Audit Risk*
- Auditing Standard No. 9, *Audit Planning*
- Auditing Standard No. 10, *Supervision of the Audit Engagement*
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*

- Auditing Standard No. 14, *Evaluating Audit Risks*
- Auditing Standard No. 15, *Audit Evidence*

The Standards are expected to be effective for audits of fiscal years beginning on or after December 15, 2010, subject to final approval by the SEC. On September 15, the SEC issued a request for public comment on the standards with responses due by October 18.

Auditing Standard No. 7 – Engagement Quality Review

The Public Company Accounting Oversight Board adopted an auditing standard, *Engagement Quality Review*, that will be applicable to all registered firms and will supersede the Board’s interim concurring partner review requirement, as well as a conforming amendment to the Board’s interim quality control standards. The objective of the auditing standard is to provide guidance for the engagement quality reviewer in performing an evaluation of the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on an engagement. The standard is effective for audits and interim reviews for fiscal years beginning on or after December 15, 2009.

PCAOB Proposes Auditing Standard on Communications with Audit Committees, Amendments to PCAOB Interim Standards

On March 29, 2010, the PCAOB proposed for comment an auditing standard on Communications with Audit Committees and a series of related amendments to its interim standards.

The proposal addresses requirements for auditors to communicate with audit committees of public company boards of directors. The proposal considers a number of factors, including the importance of accounting judgments and estimates in financial reporting. It is expected that the standard would be effective for fiscal years beginning after December 15, 2010.

In September 2010, the PCAOB held a half-day public roundtable to gain perspectives on the communications that audit committees would consider of greatest value. As a result, the PCAOB reopened the comment period on this proposal to October 21, 2010.

Compliance and regulatory matters from the SEC and others

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (“Act”) was signed by President Obama on December 17, 2010. The Act contains several provisions that are of interest to RICs and their shareholders including an extension of -

- the reduced tax rate applicable to net capital gain and qualified dividend income. This means most individuals will continue to be subject to a 15% tax rate on these amounts. The lower rates were extended for two years and will now expire after December 31, 2012.
- provisions allowing a RIC to pass-through interest-related dividends and short-term capital gain dividends. A non-US RIC shareholder is not subject to US withholding tax on these amounts. These provisions were extended for two years and will now expire for RIC tax years beginning on or after January 1, 2012.

The IRS and Treasury issued final cost basis reporting regulations on October 12, 2010. These rules will require that when brokers, including a mutual fund or its agent, report the sales of securities to the IRS, they also include the customer's adjusted basis in the sold securities and classify any gain or loss as long-term or short-term. Brokers will be required to report this information to mutual fund shareholders beginning in 2013. Issuance of the final regulations allows mutual fund service providers to move forward with their plans for implementing these rules. For more information about the final regulations see *PwC Global IRW Newsbriefs - Final regulations on cost basis are here*.

On November 3, 2010, the SEC voted unanimously to propose a whistleblower program to reward individuals who provide the agency with high-quality tips that lead to successful enforcement actions. The SEC's proposed rule under the Dodd-Frank Wall Street Reform and Consumer Protection Act maps out a simple, straightforward procedure for would-be whistleblowers to provide critical information to the agency. It conveys how would-be whistleblowers can qualify for an award through a transparent process that provides them a meaningful opportunity to assert their claim to an award. To be considered for an award, a whistleblower must voluntarily provide the SEC with original information about a violation of the federal securities laws that leads to the successful enforcement by the SEC of a federal court or administrative action in which the SEC obtains monetary sanctions totaling more than \$1 million. Certain people would generally not be considered for whistleblower awards under the proposed rules. These include:

- People who have a pre-existing legal or contractual duty to report their information.

- Attorneys who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules).
- Independent public accountants who obtain information through an engagement required under the securities laws.
- Foreign government officials.
- People who learn about violations through a company's internal compliance program or who are in positions of responsibility for an entity, and the information is reported to them in the expectation that they will take appropriate steps to respond to the violation.

The proposed rule reflects the consideration of a number of potentially competing interests, and balances the need to encourage whistleblowers to come forward without promoting unintended consequences. Comments were due by December 17, 2010.

On November 2, 2010, the SEC issued a no action letter related to Director Oversight of Affiliated Transactions. The letter was intended to clarify the SEC's view regarding fund boards' quarterly review obligations under Rules 10f-3, 17a-7 and 17e-1 under the Investment Company Act of 1940. A number of provisions of the Act and rules rely on fund boards to protect fund shareholders in conflict of interest situations. The Commission, in adopting Rules 10f-3, 17a-7 and 17e-1 did not provide that a fund board's determinations under each of these rules could be delegated. Where consistent with the prudent discharge of their fiduciary duties, fund boards may make these determinations in

reliance on summary quarterly reports of the transactions effected in reliance on one or all of these rules in the prior quarter prepared by the fund’s chief compliance officer (“CCO”) or other designated persons. Consistent with this guidance, some fund boards may decide that it is necessary or appropriate to review each transaction in order to make the required determinations under each relevant rule. Even if boards rely on the CCO or others, consistent with this guidance, to provide them with summary quarterly reports of the transactions effected in reliance on Rules 10f-3, 17a-7 and 17e-1, boards still retain ultimate responsibility for making the quarterly determinations required by these three rules, and boards cannot delegate such responsibility. As a result, even if the directors rely on others to investigate the details of each transaction, they need to be appropriately vigilant to ensure that they have sufficient information to be alerted to issues raised by these conflict transactions.

The Regulated Investment Company Modernization Act (HR 4337) was signed into law in December 2010. This bill affects RICs as follows:

- Permit an unlimited carryforward of net capital losses;
- Limit penalties for failure to satisfy gross income and asset tests;
- Modify rules for allocating capital gain dividend distributions among share classes;
- Eliminates requirements to designate the character of certain income distributions within 60 days after the fund’s year end;
- Include certain nondeductible items in earnings;
- Allow funds of funds to pass through tax-exempt interest and foreign tax credits;

- Modify rules relating to dividends, return of capital and stock redemptions;
- Reduce the negative impact of paying deficiency dividends to resolve underdistributions;
- Treat distributions in redemption of stock as an exchange of fund shares or a dividend for tax purposes;
- Allow deferral of end-of-year losses; and
- Modify excise tax and penalty rules

On September 2, 2010, the National Futures Association (“NFA”) petitioned the Commodity Futures Trading Commission to amend its rules to make RICs “commodity pool operators.” RICs are excluded from the general definition of “commodity pool operator” under current regulations. The NFA’s petition suggests that RICs are not offered enough protection under the Investment Company Act of 1940 when they are heavily invested in commodities.

On August 25, 2010, the SEC adopted changes to the federal proxy and other rules to facilitate the rights of shareholders to nominate directors to a company’s board. The new rules require companies to include the nominees of significant, long-term shareholders in their proxy materials, alongside the nominees of management. This “proxy access” is designed to facilitate the ability of shareholders to exercise their traditional rights under state law to nominate and elect members to company boards of directors.

In light of the Dodd-Frank Act provision eliminating reliance on NRSROs from many Federal laws and regulations, on August 19, 2010, the SEC issued a letter to the Investment Company Institute alleviating fund boards from the recently adopted amendment to 2a-7 that would require them to assign four or more NRSROs which the fund would use in determining eligible securities for money funds. In the meantime, funds

and their boards should continue to monitor the eligibility of the securities for money funds as they did prior to the adoption of the amendment.

On August 19, 2010, the SEC granted the Investment Company Institute (“ICI”) relief for the newly implemented amendment to rule 2a-7 regarding short-term floating rate securities. The ICI received an exception from *Rule 2a-7(c)(2)(iii)* under the Investment Company Act of 1940 which allows money market mutual funds to treat short-term floating rate securities with a demand feature the same as short-term variable rate securities for determining portfolio maturity.

On June 16, 2010, the SEC voted to propose amendments to assist investors in understanding the investment profile and risks related to target date funds. The proposed rules would require marketing materials to more clearly articulate the asset allocation strategy for the life of the fund. Additionally, marketing materials must include several specific statements: a) to consider various factors (including age, risk tolerance and full personal financial situation) before investing; b) that investments are not guaranteed and that investors may lose money; and c) the extent to which overall investment allocations may be modified without requiring a shareholder vote.

Publications of interest to mutual fund directors issued during the three years ended December 31, 2010

Independent Directors Council/Affiliates (www.idc1.org)

Board Oversight of Subadvisers, January 2010

The report discusses the business reasons for retaining a subadviser and industry trends in the use of subadvisers. The report also explores board oversight of subadvisers, starting from the time a principal adviser recommends hiring a subadviser, through board approval of the subadvisory agreement and ongoing board oversight of the subadviser, to possible termination of the subadviser. At each step, the report explores potential issues and considerations of particular interest to boards overseeing subadvised funds. A task force composed of independent directors, in-house fund lawyers, and compliance personnel developed the report.

Navigating Intermediary Relationships, October 2009

Intermediaries such as broker-dealers, fund supermarkets, and financial advisers provide important distribution and other services to mutual funds and their shareholders. This paper describes the important roles of these intermediaries in the mutual fund industry and discusses ways their roles evolve with the changing business and regulatory environment. Appendix H provides examples of high-level potential board questions for fund management concerning

these relationships.

Board Oversight of Fund Compliance, September 2009

The task force report's goal is to provide fund board members and others a comparison of the various practices used by funds to structure, evaluate, and pursue compliance. It is designed to assist them in evaluating compliance.

SEC Valuation Guidance Compendium, July 2009

The Investment Company Institute (ICI) created a new site to capture SEC valuation guidance that applies to mutual funds when they calculate net asset values at which capital share purchases and redemptions are transacted. The ICI intends to keep the site evergreen, with the latest comprehensive SEC valuation information for investment companies.

Report of the Money Market Working Group, March 2009

The report includes a series of recommendations designed, among other things, to make money market funds more resilient in the face of extreme market conditions such as those encountered in September 2008. Many of these recommendations can be implemented on a voluntary basis; the working group encouraged the industry to comply by September 18, 2009, when authorization for the Treasury Temporary Guarantee Program for Money Market Funds expired.

Board Oversight of Derivatives, July 2008

This overview of derivatives used by mutual funds provides suggestions for board oversight of derivatives' portfolio management; operations; regulatory compliance matters, including valuation, accounting, and financial reporting; and the treatment for federal income tax purposes. It also includes a number of appendices, including one that covers potential topics for board adviser discussions regarding derivatives included in mutual fund portfolios.

Mutual Fund Directors Forum www.mfdf.com

Practical Guidance for Directors on the Oversight of Risk Management

This report provides guidance for directors on effective risk management and the board's oversight role.

Practical Guidance for Directors on the Oversight of Subadvisers, April 2009

This report provides independent directors with guidance in overseeing all phases of their funds' subadvisory relationships—from entering relationships, to monitoring existing relationships and ending relationships.

Practical Guidance for Directors on Board Self-Assessments, January 2008

This report provides guidance on board self-assessments, including recommendations that boards ensure that every director is involved, provide all directors with adequate opportunity to discuss findings, and plan follow-up action after the self-assessment is complete.

PricewaterhouseCoopers www.pwc.com

A first look at the Regulated Investment Company Modernization Act of 2010

The Regulated Investment Company Modernization Act of 2010 (the "Act") was signed by President Obama on December 22, 2010. The Act represents the culmination of the mutual fund industry's efforts in recent years to modernize various tax rules applicable to regulated investment companies (RICs or funds). Collectively, these changes are among the most significant to affect RICs since the Tax Reform Act of 1986. This publication summarizes the key provisions of the Act, notes particular areas for your consideration, and offers PwC's observations and insights.

Setting the Standard: What you need to know about the FASB and IASB's joint projects, December 2010

Yielding to mounting time pressures and resource constraints, the boards once again are making course corrections. On November 29, 2010, the FASB and IASB published an updated work plan and timeline for their joint projects. While the boards reaffirmed that their target completion date of June 2011 is still a go for certain priority projects, work on most others will now have to wait. What timing can we expect for the non-priority projects? At best, look to the second half of 2011. The boards' key message: they need to keep their eye on the chief objective of developing high-quality, improved, and converged standards.

In Brief - An overview of financial reporting developments, December 2010

On November 29, 2010, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) published a progress report that outlines a revised plan and timeline for their convergence projects. This publication provides an overview of the reprioritized convergence strategy.

In Brief - Boards delay timing for Financial Statement Presentation and Financial Instruments with Characteristics of Equity projects, October 2010

At the joint board meetings on October 21 and 22, 2010, the FASB and IASB decided to further delay the timeline on two joint projects: (1) financial statement presentation and (2) financial instruments with characteristics of equity. This publication provides an overview of the projects and how they are impacted.

The Quarter Close – Directors edition, October 201

The Quarter Close – Directors edition was recently developed as a new complement to PwC’s long-standing publication, The Quarter Close. The Q3-2010 edition examines changes at the FASB and provides overviews of the latest exposure drafts on key projects from standard setters, and recent tax legislative changes.

Asset Management Valuation Survey, November 2010

PwC conducted a survey designed to gather, analyze and share information about emerging trends in the valuation governance process. The survey was designed to gather data from industry participants in order to help executives and other stakeholders benchmark their valuation governance practices against their peer group across the asset management industry, including the traditional/registered, alternative, private equity and venture capital and real estate sectors. PwC polled more than 50 US-based managers of varying sizes, with 2 of the participating firms managing less than \$500 million in assets, and 12 of the participating firms managing more than \$100 billion.

Pay to play, September 2010

The SEC voted to adopt a new rule, Rule 206(4)-5, under the Investment Advisers Act of 1940 on June 30, 2010

to address “pay-to-play” issues relating to relationships between investment advisory firms and political officials who have control over, or the ability to appoint someone to control, the investment decision-making for public pension plans. The Rule limits the political contributions (federal, state, and local) that investment advisers and certain current and prospective employees can make. This publication outlines the elements of the Rule, recordkeeping requirements, and effective dates as well as additional considerations chief compliance officers should consider.

Annual Corporate Directors Survey - 2010 Results, November 2010

PwC’s Annual Corporate Directors Survey collects the opinions of more than 1,000 directors serving on the boards of the top 2,000 publicly traded companies (by revenue) listed with the NYSE Euronext, the NYSE Amex, and the NASDAQ OMX Group stock exchanges. The survey covers issues such as risk management, compensation, director evaluations, director experience mix and board diversity, to name just a few. This marks the ninth year for the annual survey, formerly titled What Directors Think.

2011 Current Developments for Directors, December 2010

This annual report captures the critical governance issues directors and senior executives face. A special focus section has been added in this year’s publication to highlight some of the factors that are influencing companies’ growth plans. It highlights how new global trends are affecting companies’ operations and international expansion opportunities. This year’s publication also covers how regulatory reform, financial reporting developments, and tax reform may affect companies.

Point of View: slowing down the pace of standard setting July 2010

The FASB and IASB are working on several joint projects designed to improve both U.S. generally accepted accounting principles and International Financial Reporting Standards. These projects are part of a wider goal to converge U.S. and International Standards in key areas by 2011. While convergence is an important component of achieving a single set of high quality global accounting standards, some question whether the current pace and timeline is realistic. PwC believes, that, despite the recently announced modified strategy for certain projects, the timeline is still aggressive and does not allow enough time for constituent input and the boards' thoughtful rigorous processes in order to achieve the boards' desire for high quality output. Read this publication for additional background, analysis, and Q&A on these issues.

CBI/PricewaterhouseCoopers Financial Services Survey, June 2010

The 83rd survey shows a gentle further improvement in confidence and levels of activity, but with increasingly upbeat predictions for the coming quarter. Other encouraging signs include plans to expand headcount and an expectation that non-performing loans will start to fall. On the downside, regulatory costs are rising fast and respondents are concerned about further deterioration in the financial markets.

Working Guide for an Investment Company's Audit Committee, June 2010

The guide presents considerations for audit committees in a number of areas, with significance to open- and closed-end funds' financial statements and their internal control, as well as matters pertaining to their relationships and communications with management and internal and independent auditors.

Setting the Standard: What you need to know about the FASB and IASB's joint projects, June 2010

The FASB and IASB have continued to sustain an unprecedented pace of standard setting activities, now working towards a goal of finalizing a number of major joint projects over the next 18 months. Many of the projects being tackled are significant and stem from the FASB's and IASB's Memorandum of Understanding (MoU). The boards have made progress on a number of initiatives and have released several proposals. However, despite these efforts, questions have surfaced about whether the boards need to slow down and map out their priorities.

FS Regulatory Briefs: Fund Directors and the New Proxy Disclosure Rules June 2010

This publication is aimed at helping directors assess how well their funds comply with the enhanced proxy and fund governance disclosure requirements. This edition addresses the actions of directors with regard to: (1) proxy disclosure enhancements; and (2) the voting of proxies for portfolio companies.

Broker-Dealer and Investment Adviser Compliance Programs – Regulatory requirements, common minimum elements, other paradigms, May 2010

Investment advisers and investment companies are required to have compliance programs pursuant to rules of the Securities and Exchange Commission, and broker-dealers are required to have compliance programs pursuant to rules imposed by FINRA. These rules have certain common features – effectively creating “minimum elements” for broker-dealer and investment adviser compliance programs. The separate regulatory requirements governing advisers' and broker-dealers' compliance programs are summarized in this publication, as well as these common “minimum elements.”

The second generation of global investment performance standards, April 2010

The Global Investment Performance Standards (GIPS®), which enable asset managers to voluntarily provide standardized and transparent measures of their performance, have been in effect in nearly 30 countries since 2005. Compliance with GIPS can serve as an important independent source of validation for a manager's performance. This publication provides PwC's perspective and analysis on GIPS 2010 which becomes effective on January 1, 2011, introducing changes that will pose additional challenges for asset managers.

Lead Directors: A study of their growing influence and importance, April 2010

This paper discusses what directors see as the most important elements of their service now and in the future.

IRS releases draft schedule and instructions for uncertain tax positions (a WNTS publication) April 2010

This publication discusses general and specific instructions regarding Announcement 2010-30, which accompanies the draft schedule (Form 1120, Schedule UTP).

2010 Current Developments for Directors, December 2009

This publication is aimed at helping directors and senior executives understand and address the most important challenges they face. This year's edition addresses, among other things: (1) business challenges in this difficult economy; (2) corporate governance initiatives; (3) regulatory and tax updates; (4) major ongoing legislative initiatives; (5) key financial reporting developments; and (6) acquiring assets out of bankruptcy. In addition, a special focus section discusses challenges resulting from

the significant increase in government involvement in business over the past year.

Valuation Process Transparency: Demands challenge asset managers and directors, September 2009

This publication provides PwC's views on five oversight questions that senior executives and directors of asset-management firms are asking about the valuation process. It provides suggestions to ensure that executives, directors, and investors are provided protection.

Seeking transparency in uncertain times: Refocusing your investment adviser due diligence program, September 2009

This publication provides PwC's perspective on how effective due diligence processes covering advisers and subadvisers in uncertain times; in such an environment, control processes and compliance may be the equal of investment performance in assessing which advisers institutional investors will retain to manage money.

Day After Tomorrow, July 2009

This new global publication focuses on how the asset management industry is likely to respond to the crisis of late 2008. PwC believes that the consequences for asset managers globally are likely to be profound and will last for a long time.

Executive oversight: Meeting governance and oversight challenges in a difficult economy, May 2009

This paper highlights the areas where PwC believes investment management senior executives and board members should focus their governance efforts in response to the realities of today's economic environment.

Investment management and real estate perspectives, April 2009

PwC's annual outlook of trends and issues affecting the asset management industry offers commentary and forecasting from industry leaders on the market environment.

Why change money market funds? April 2009

This paper discusses the growing debate regarding the call for money market change and new regulation resulting of the credit crisis. It shares recent activities, opinion, and testimony on the topic, and poses questions for consideration as the oversight debate continues.

Similarities and differences: A comparison of US GAAP and IFRS for investment companies, October 2008

PwC offers this publication as a general explanation of the key similarities and differences between IFRS and the accounting principles generally accepted in the United States as they specifically apply to investment companies.

Investment company pricing and valuation: A focus on management responsibilities and board oversight, September 2008

This publication is an updated edition of PwC's pricing and valuation guide to assist management of investment companies and their boards of directors in meeting the increasing challenge of portfolio securities valuation. The guide contains an overview of current and emerging investment company pricing and valuation practices, as well as topical questions that PwC believes will help fund boards and management (including pricing and valuation committees) assess the design and operating effectiveness of fund valuation policies and practices.

The Mutual Fund Advisory Contract Review Process: Simplifying Complexity, April 2008

This publication provides PwC's perspective on how the investment adviser and board may be able to make the advisory contract review process more productive and mutually beneficial. The publication includes perspectives on how to approach the process and measure investment adviser profitability, and provides a framework for the assessment of investment adviser profitability.

SEC

www.sec.gov

Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies— Select Bibliography of the Division of Investment Management, March 2009

This bibliography lists relevant provisions of the Investment Company Act of 1940, its rules, Commission releases, staff guidance, and enforcement actions related to securities valuation. Directors, legal counsel, and others may find this information useful when researching the SEC's positions on valuations.

Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-To-Market Accounting, December 2008

This study recommends that existing fair value (i.e., FASB Statement No. 157) and mark-to-market requirements under GAAP should not be suspended. The study does recommend improvements to existing accounting standards and practice, however, including reconsideration of the accounting for financial asset impairments and

development of additional guidance for determining fair value. Although this study explicitly did not apply to investment companies, it does provide some insight into how the SEC views FAS 157. Moreover, some of the proposed changes to GAAP address issues that apply to investment companies. Among other things, the study recommends consideration of the following:

- Additional application guidance or best practices for determining fair value in illiquid or inactive markets
- Enhancing existing disclosure and presentation requirements related to the effect of fair value in the financial statement
- Educational efforts, including improving the application of reasonable judgment in the determination of fair-value estimates
- Examination by the FASB of the impact of liquidity in the measurement of fair value
- Tools:
 - How to determine when markets become inactive
 - How to determine whether a transaction or group of transactions is forced or distressed
 - When observable market information should be supplemented with and/or reliance placed on unobservable information in the form of management estimates
 - How to confirm that assumptions utilized are those that would be used by market participants and not just by a specific entity

The study also suggests that FASB consider whether the role of FASB's Valuation Resource Group (VRG) should be expanded "to function more like FASB's [Emerging Issues Task Force]," including the use of subcommittees to address specific issues and opening the VRG's meetings to the public.

Final Report of the Advisory Committee on Improvements to Financial Reporting to the United States Securities and Exchange Commission, August 2008

This final report contains 25 recommendations to increase the usefulness of financial information to investors, while reducing the complexity of the financial reporting system to investors, preparers, and auditors. The committee believes that these recommendations could be implemented by the SEC, the FASB, the Public Company Accounting Oversight Board (PCAOB), or their respective staffs, as appropriate, without legislation. The committee decided not to focus on the convergence of US GAAP with IFRS. Because the convergence may take years to achieve, the committee believes that it is fruitful to recommend enhancements to the current financial reporting system in the United States. The progress report contains the committee's developed proposals, conceptual approaches, and matters for future considerations to improve the financial reporting system in the United States.

Contact us

For more information about any of the information shared in this newsletter, please feel free to contact any of the following practice leaders, or your local PwC representative. We would welcome the opportunity to speak with you.

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