October 24, 2012

2012 Financial Services

Audit Committee Forum

Asset Management

pwc

Welcome

Peter Finnerty
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Agenda

October 24, 2012

Regulatory update panel

2:15-3:00pm

Roundtable discussion: Valuation risk

3:00-3:30pm

Break

3:30-3:45pm

Roundtable discussion: Board effectiveness

3:45-4:15pm

Accounting & tax update panel

4:15-5:00pm

Current compliance and regulatory issues for funds and boards

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Managing Director, FS Regulatory Practice, PwC

Today's topics

- The board's role in compliance: Some current issues
- Approaches to compliance testing
- The critical role of investment adviser committees in fund compliance
- Some current compliance hot topics:
  - Valuation/Leverage
  - 15(c) board re-approval process
  - Fees/Expenses
  - Fund Marketing
  - Worst case scenario: When violations occur
- On the horizon: New regulations
- Q&A

The Board's role in compliance

Some current issues

The Board's role in compliance
Some current issues

- **Goal of the rule**: Rule 38A-1, the "Compliance Program Rule," is intended "to strengthen the hand of fund boards and compliance personnel when dealing with [fund management]" (Compliance Programs of Investment Companies and Investment Advisers, Release No. IA-2204, December 17, 2003).
- **What is required?** The rule requires fund directors to adopt written policies and procedures that are reasonably designed to prevent a fund from violating federal securities laws and that provide for the oversight of advisers, principal underwriters, administrators, and transfer agents.
- **The "back-story"**: A driving purpose of the rule is to empower fund boards to obtain information from management. The SEC stated: "We have observed that compliance failures have occurred when a fund service provider has denied information to a fund's board…because it viewed full disclosure as detrimental to its own interests."

The Board's role in compliance
Some current issues

- **How?** The primary way that fund directors exercise their compliance program oversight obligations is by receiving information from the fund CCO.

The SEC's chosen mechanism for enhancing information flow to the board was the creation of the CCO position with a direct line of reporting to the board – unfiltered and outside of management control.

- **No one model is mandated**: The SEC deliberated over the conflicts involved where a fund CCO is employed by the adviser. After considering industry comments, the SEC determined not to mandate any specific model or to require that fund CCO's be employed away from the adviser, realizing the practical limitations this could have on the effectiveness of a compliance program.

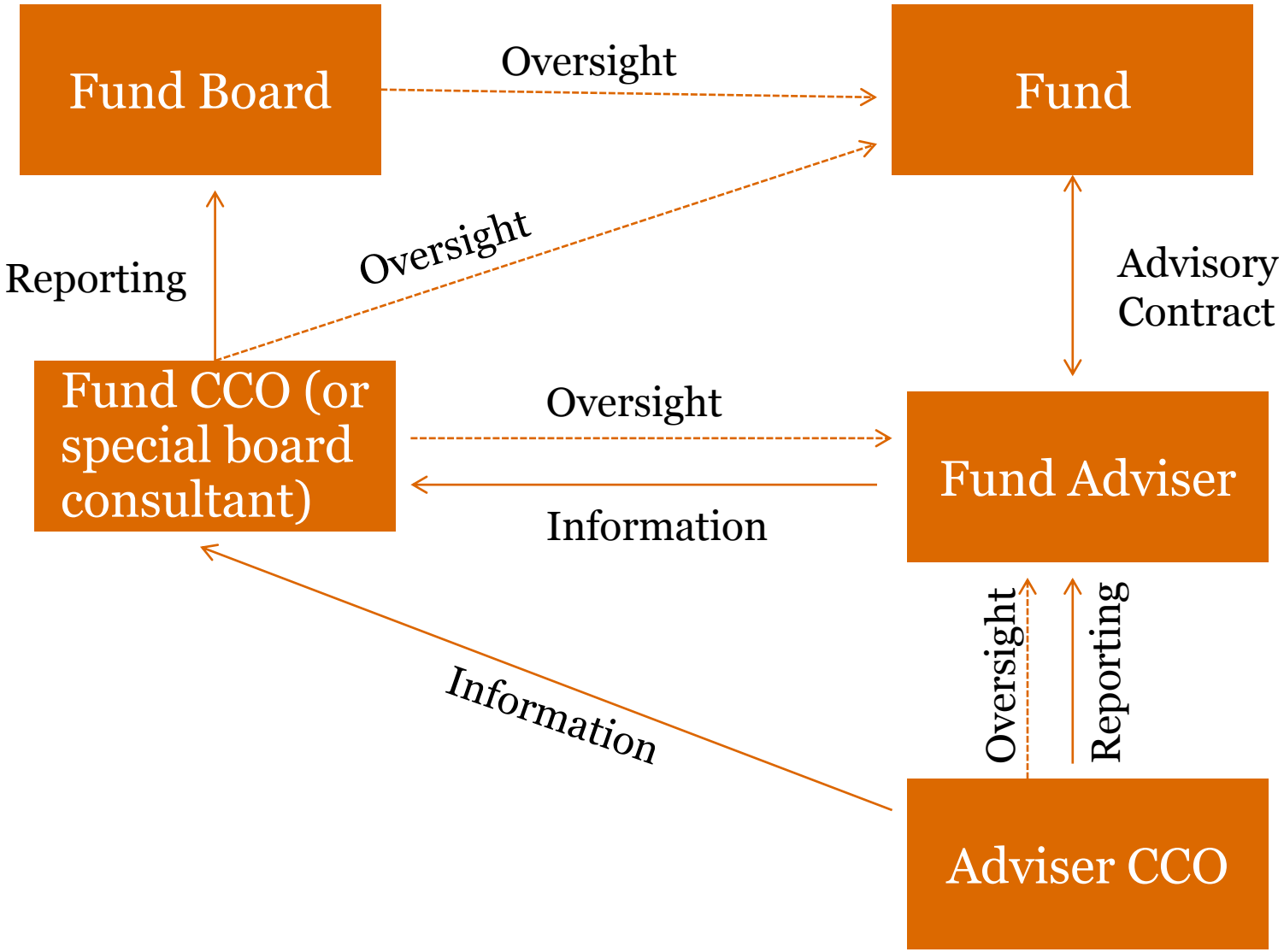
The Board's role in compliance
Some current issues

Fund complexes and boards continue to review the basic structures of their compliance programs – even as the 10th anniversary of the rule approaches–including different ways to combine/separate fund and adviser compliance programs.

- **Practices are changing**: According to a recent survey of CCOs by Management Practice, Inc. 58% of participants were full-time employees and served as CCO to both the fund and the advisor in 2011—down from 78% in 2008.
- **Whatever model is used, boards' relationship with their CCO is key**. Fund boards need to mitigate potential disadvantages of their funds' particular models by strengthening their rapport and the reporting relationship with the fund CCO.

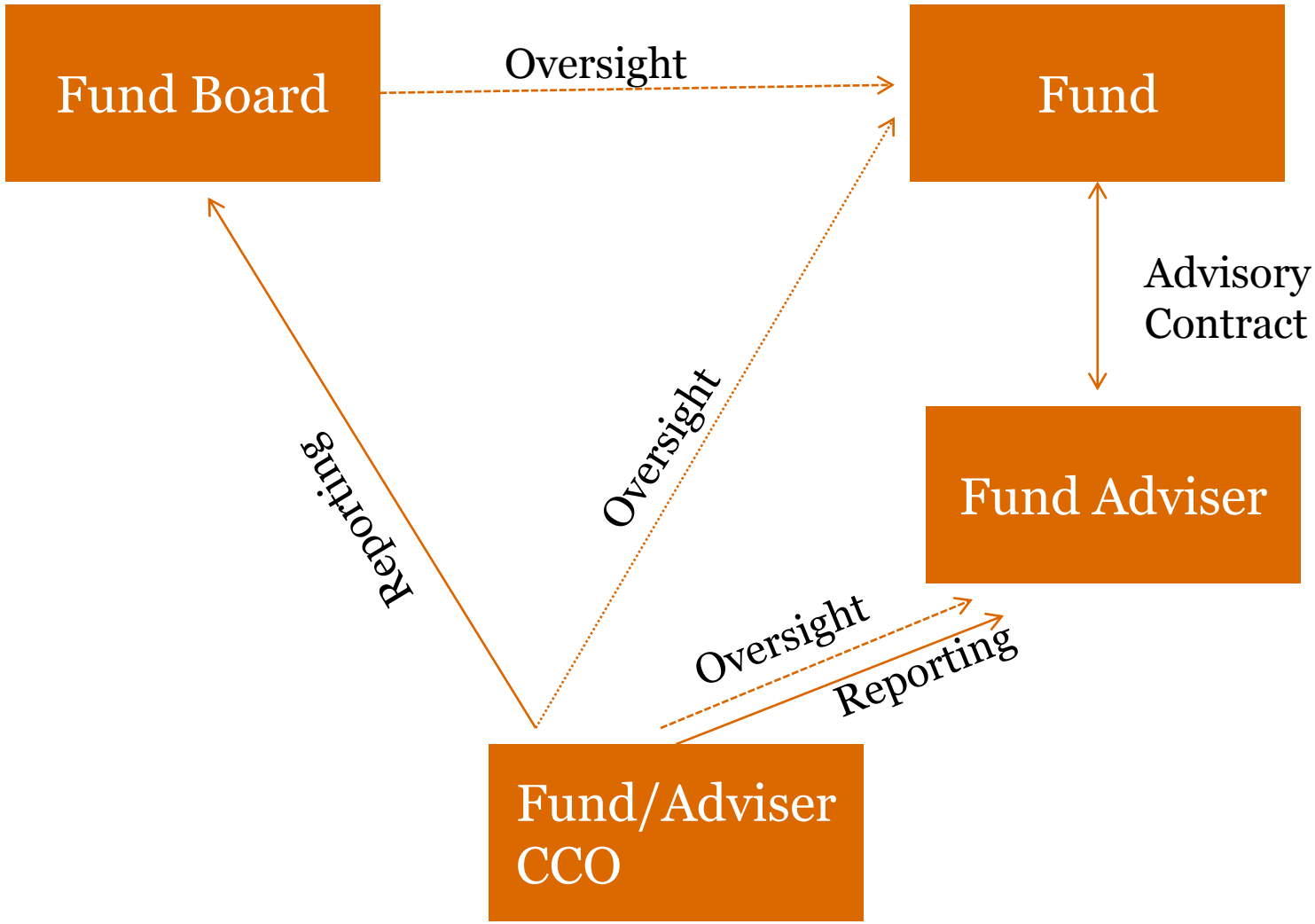
Organizational options

Fund compliance models: separate fund and adviser CCO



Organizational options

Fund compliance models: a single fund/adviser CCO



The Board's role in compliance
Some current issues

Advantages and disadvantages of an independent fund CCO

Advantages

- Focused attention on fund and board issues
- Less division of loyalty, time, attention
- Single direct reporting relationship to board
- Internal/external perception of independence
- Lack of organizational pressure on CCO in determining materiality of board-reporting items

Disadvantages

- Perception of CCO by Adviser as an "outsider"
- Role limited to oversight of the Adviser's policies and procedures while being apart from the Adviser's operations
- Information flow to Board and CCO filtered through management
- Less understanding of Adviser's standard operations and controls as applied to funds and other clients
- Less oversight of Adviser's compliance testing program and ability to influence test areas

The Board's role in compliance
Some current issues

Reporting to the board: What information does the Board need concerning the compliance program?

The Compliance Program Rule requires that "material" compliance matters be reported including "violations of the federal securities laws or compliance policies and procedures… as well as weaknesses in the design or implementation of those policies and procedures about which the fund's board reasonably needs to know in order to oversee fund compliance."

- **Be sure to see the forest and not just the trees**: The SEC staff has stated: "Individual compliance matters that, taken in isolation, may not be material may collectively suggest a material compliance matter, such as a material weakness in the compliance programs of the fund or its service providers."
- **Reporting is evolving**…Boards are obtaining greater insight into the operation and effectiveness of the compliance program.

The Board's role in compliance
Some current issues

Hallmarks of effective board/CCO communications and reporting

- **Board develops strong rapport** with their CCO and a level of trust and confidence via regular communications.
- **Routine reporting across a broad spectrum of compliance issues**, including trend reporting, strengthen trust by lessening the CCO's discretionary judgement used in deciding what to report to the board.
- **The board and CCO agree on topics** and establish a schedule to conduct deep-dive testing and reporting on specific compliance topics.
- **Board has input into formal employee evaluation cycle** as it relates to the CCO, and agreement by the adviser that such input will be given appropriate consideration in compensation decisions.
- **Boards prioritize periodic executive sessions with CCO**.

Approaches to compliance testing

Approaches to compliance testing

- **A core compliance program framework** consists of:
  - Compliance risk assessment;
  - Written policies and procedures;
  - Defined roles and responsibilities;
  - Training and communication;
  - Monitoring, **testing** and reporting; and
  - Response/issue resolution.
- **No mandated standard or framework for annual rev**iews: The SEC did not impose a single model for conducting annual reviews of compliance programs in recognition of significant differences among funds and advisers with respect to size, business models, operational structures, products, systems and risks.
- **Uncertainty regarding testing**: While there is recognition that some level of testing is requisite for an effective compliance program, there are persistent questions regarding selection of test areas, the level of detail involved, timing, responsibility for performing tests, test reporting, and SEC expectations.

Approaches to compliance testing

- **Testing is expected**. The term "forensic testing" is not incorporated in the text of the Compliance Program rule, but the SEC has made reference to it in the rule's footnotes and in other speeches and presentations – stating that it involves assessing patterns of information over time – as opposed to spot checking.
- **Testing aids the CCO**. Similarly, fund boards should request compliance trend reports that show patterns over time – regardless of whether a particular issue or violation is considered "material."
- **Some funds have dedicated testing units**. Dedicated testing units can help to enhance consistency, quality, reporting, and the professional level of review.

Boards should regularly consult with the adviser and CCO(s) regarding priority test areas, based on industry events, past results and perceived risks. Results of testing can be included in regular reports to the board.

The critical role of investment adviser committees in fund compliance

The critical role of investment adviser committees

- **Governance matters**: Formal committees are key to a successful compliance program within a large fund adviser. Committees form a critical check and balance and separation of duties regarding key decisions and oversight.
- **Many fund complexes have numerous committees**: Large, complex advisers typically have many committees, including the following which are essential to the compliance program: Valuation, Brokerage Practices, Compliance/Conflicts, Code of Ethics, Risk, Disclosure and Investments.
- **Compliance has a role in committees**: The adviser's compliance personnel typically participate on many committees, directly or as consultants, and often a fund's independent CCO may be invited to sit-in as a non-voting observer.

The critical role of investment adviser committees

- **Trend is towards more formal operation of committees**: Effective committees are backed by formal charters which cover the purpose, membership, duties, meetings and actions of the committee.
- **Committees can facilitate business recognition and support of compliance**: Successful advisers have used their formal committees to enhance business-unit buy-in of the compliance program by assigning ownership of formal policies and procedures to the committees.
- **Messaging**: Impactful governing committees represent tangible evidence of "tone from the top" with respect to a firm's culture, compliance and ethics.

In order to successfully oversee a fund's compliance program, fund boards need insight to the adviser's committees activities and operations.

Current mutual fund hot topics for boards

Compliance "hot topic"
Valuation/leverage

- **"Stretching" risk**: Low market yields and interest rates may cause advisers to reach for performance by investing in new products or strategies.
- **Leverage in the spotlight**: The Head of the SEC's asset-management enforcement unit has stated that mutual funds' use of leverage is a key focus.
- **Valuation is still a focus**. The SEC's valuation-related cases focus on process, policies, disclosures, valuation committees, and price overrides.

SEC Chairman Schapiro stated that the typical controls in place around stocks and bonds can lose their effectiveness when applied to derivatives.

- **"Outlier" performance**: SEC enforcement and exams looking for valuation and leverage issues by looking for outlier performance among peer funds.

Compliance "hot topic"
Valuation/leverage

What directors can do

- **Establish routine reporting** to board regarding the types and amounts of derivatives used, whether they are independently valued, and how their use has increased/decreased in recent periods.
- **Set variance thresholds** to require detailed performance attribution reports to board if a fund underperforms or outperforms peer funds by a certain amount.
- **Study Release** 10666 (4/18/79). Review Section 18f-1 compliance testing and reporting performed by the fund's adviser. Probe how the adviser ensures that each fund has segregated sufficient assets or covered its positions so as to avoid "leverage" as defined in the release and related interpretations.
- **Consider hiring outside experts** to conduct testing around compliance with fund/adviser valuation policies and procedures.
- **Determine if adviser routinely uses investment or market risk measures** (such as VAR), and whether trends in these measures might be instructive to board.
- **Periodically review or have fund CCO report** on minutes of adviser's Investment Committee or Derivative Products Committee, especially discussions around approval of new types of investments.

Compliance "hot topic"
15(c) process

- **Enforcement focus**. The SEC's asset-management enforcement unit is focused the annual 15(c) process for re-approving advisory contracts.
- **Law**. Section 15(c) of the IC Act requires advisers to furnish such information as may reasonably be necessary for fund directors to evaluate the terms of any advisory contract with the fund.

Two recent enforcement cases accused advisers of failing to provide information reasonably necessary for boards to evaluate the nature, quality, and cost of the advisers' services; one case also charged an adviser for failure to supervise a sub-adviser in connection with the contract renewal.

- **Insufficient diligence?** The SEC is also looking for cases against directors for insufficient diligence and evaluation in connection with contract re-approval.
- **Wells-Notices** were issued to current and former directors of an "umbrella trust" in a recent case, although SEC's public settlement was against adviser.

Compliance "hot topic"
15(c) process

What directors can do

- **Conduct a self-evaluation or hire outside consultant** to review board's 15c process and performance. Ask – "What can we do better this year?"
- **Keep process and reports focused on the basic questions**: "Should we retain the adviser?" "If so, why – and how much should the adviser be paid?"
- **Ensure to document** not only the reports and information provided to the board, but the deliberative steps the board took to consider, discuss and question the information and reach a decision.
- **Ask for due diligence reports and compliance certifications** from any sub-advisers used by the funds, especially small and foreign sub-advisers who have been in place a long time and not made any presentations before the board.

Compliance "hot topic"
Fees/expenses

- **A continuing focus**. Examinations and enforcement cases focus on all fee arrangements with registered funds.
- **Two areas are particularly in focus**:
  - Accounting and operation of **mutual fund fee waivers** (voluntary and contractual) used to strategically adjust net advisory fees to current realizations in performance and expected fund flows.
  - **Revenue sharing** in the form of sub-TA fees paid to intermediary broker-dealers; the SEC may view such payments suspiciously as fund assets used to promote fund-share sales in violation of Section 12(b) of the IC Act.

OCIE Deputy Director recently announced a "fact-finding mission" into distribution arrangements which could lead to rulemaking, guidance or enforcement actions. Part of SEC's focus is the role of the board.

Compliance "hot topic"
Fees/expenses

What directors can do

- **Determine that adviser has actually foregone fees to meet fee-waiver or reimbursement commitments** as opposed to merely recording a payable to the fund.
- **Have CCO undertake a forensic review** of fund cash disbursement journal and invoices to probe for any new types of expenses which were not paid for by the fund in the past.
- **Request a detailed report of all intermediaries receiving sub-TA fees** including the amounts paid and whether fees are based on average AUM or number of accounts; the number and dates of any increases in sub-TA fees paid to each intermediary; and whether there was a revenue sharing arrangement in place prior to payment of sub-TA fees.
- **Probe the adviser** around the negotiations for sub-TA fees, and to what extent if any fund distributor personnel participated in the negotiations.
- **Document board's conclusion** that a financial intermediary is providing incremental services for its customers holding shares of the fund. Examples of such services could include processing of redemption fees, CDSLs, exchanges between funds, and shareholder mailings.

Compliance "hot topic"
Fund marketing

- **Disclosure rules –** Most of the subprime mortgage cases and other recent marketing cases involving mutual funds have a common theme: *failure to accurately disclose investment objectives and risk exposures.*
- **The biggest cases since 2008 have revolved around disclosure** and marketing statements made during investor calls, in printed materials, in prospectuses and on fund/adviser websites.
- **Truth in advertising –** While the IC Act has very few restrictions on the type or size of investments or strategies, funds must be managed as advertised.
- **SEC focus –** The SEC will focus on overly aggressive marketing practices – including marketing of "money market-like funds" – especially as adviser margins shrink and overall AUM consolidates.
- **Oversight –** Directors must also be weary of how fund distributors conduct oversight of selling broker-dealers.

Compliance "hot topic"
Fund marketing

What directors can do

- **Periodically review risk disc**losures in fund prospectus.
- **Invite portfolio managers to board meetings** and gauge their knowledge of risk disclosures; ask how portfolio managers gain comfort that the fund is being managed as it has been described to shareholders.
- **Assess the key investment risk indicators** (e.g. VAR, exposures, market correlations, leverage, etc.) relied upon by the fund/adviser chief investment officer and chief risk officer; consider requesting trend reports to the board showing changes over time to the key risk indicators.
- **Request that the fund distributor make a presentation** on its role and oversight regarding the sales practices of selling brokers.
- **Determine whether the fund distributor routinely obtains regulatory exams, FINRA reports or other adverse data searches regarding selling brokers**, and what criteria (if any) the distributor has for maintaining/ending sales agreements.

Worst case scenario
When violations occur

Several key initiatives are impacting SEC enforcement cases:

- **The Asset Management Enforcement Unit**: Bruce Karpati, head of the unit, recently stated that 75 person staff is spending over 1/3 of its time investigating registered fund cases.
- **Whistleblowers**. Under rules required by Dodd-Frank, tipsters received between 10-30% of collected monetary sanctions. The SEC has reported receiving over 100 quality tips per day.
- The Enforcement Division's **cooperation program**, which includes guidelines to reward assistance and self-reporting through cooperation agreements, deferred prosecution agreements and non-prosecution agreements.
- **More resources** for examinations and regulatory proceedings involving investment advisers (potential movement on SRO for advisers).

On the horizon

New regulations

Current state of the money market fund debate

September 2008	Lehman fails; Reserve Fund breaks buck; investors pull about $300 billion from prime money market funds; sponsors provide support; Treasury and Fed institute guaranty programs
Marc h 2009	ICI Money Market Working Group Releases reform study
September 2009	End of Treasury/Fed MMF guaranty programs
January 2010	SEC adopts amendments to Rule 2a-7, tightening limits on quality, duration, liquidity, and transparency(10% of assets must have daily liquidity, 30% must have weekly liquidity; maximum weighted average maturity reduced to to 60 days, with a weighted average life of 120 days or less)
October 2010	President's Working Group Releases Report concluding that additional MMF reforms are needed
June 2012	Fed Governors criticize SEC for inaction, and suggest tighter controls on banks' access to MMF funding and required capital buffers for bank-sponsored MMFs
June 2012	Chairman Schapiro testifies SEC is preparing a rule proposal that would make funds choose Between floating their NAVs or instituting capital buffers and redemption limits; cites 300 cases of sponsor bail-outs
August 2012	SEC abruptly cancels scheduled public meeting to propose new rules due to lack of majority support on Commission; Chairman Schapiro urges FSOC to use its authority to act
September 2012	SEC Commissioner Gallagher indicates that he'd support a floating NAV requirement. Treasury Secretary Geithner sends letter to FSOC calling on it to take action to seek public input on reforms and thereafter to direct SEC to act. Also calls on bank regulators to take steps within their authority

Current state of the money market fund debate

- **To address the risk of destabilizing "runs" on MM funds**: SEC Chairman Schapiro sought additional reforms. Bank regulators also frequently and publicly called for further reforms – calling MM funds susceptible to runs that could destabilize broader financial markets. International regulators also recommending reforms.
- **No SEC proposal**. SEC Chairman Schapiro was unable to get a majority vote to release the rule proposals. Unusual public disagreement among commissioners.
- **Choice**: The proposal would have given MMFs a choice: float the NAV, or continue to rely on 2a-7 safe harbor by instituting a 1% capital buffer and a 3%/30-day redemption hold-back.
- **Fund industry**: Reforms are harmful or even destructive to the industry: i.e., investors' desire a stable NAV product; would disrupt a crucial source of financing for businesses, states, counties, and cities; operational difficulties to implement; 2010 reforms are adequate.

Current state of the money market fund debate

- **Tense game now shifts to FSOC**. Treasury Secretary Geithner asked FSOC to propose options for public comment, and then to direct SEC to take action (authorized under Dodd-Frank).
- **FSOC process and authority will be tested**. Can it designate certain large MMF sponsors or perhaps the entire industry as systemically risky?
- **Bank regulators could also impose limits** on bank reliance on MMF financing or impose mandatory capital buffers on bank-affiliated MMFs.
- **Secretary Geithner**: The goal should be to propose reforms that protect the stability of MM funds "without creating a competitive advantage for unregulated cash-management products."

CFTC
CPO registration

- **New fund registration**. In February, the CFTC eliminated long-standing exemptions (CFTC Rule 4.5) to commodity pool operator registration requirements; as a result, most advisers to funds with investments in commodities will have to register as CPOs.
- **Overlapping jurisdiction**. The CFTC's purview overlaps with existing SEC oversight of mutual funds, resulting in a duplicate framework that may lead to new compliance challenges for mutual funds, their advisers and service providers.

Exclusions

To avoid registration, advisers will have to establish either that:

- The fund's aggregate initial margin and premiums on commodity futures and options (exclusive of bona fide hedges) is less than five percent of the fund's NAV; *or*
- The aggregate net notional value of derivatives positions (exclusive of bona fide hedges) is less than the fund's NAV, including profits and losses on such positions.

CFTC
CPO registration

- **New reporting requirements**. The rules also establish new annual, and in some cases quarterly, reporting requirements. For example, Form CPO-PQR requires disclosure of information similar to the SEC's Form PF (for non-registered funds), such as a fund's size, objectives, and risk exposures.
- **Effective and compliance dates**. December 31, 2012. Advisers to funds using futures and options had to register by October 12, 2012.
- **Under challenge**. The ICI and U.S Chamber of Commerce have filed a lawsuit to challenge the CFTC's actions; a court decision may come this fall.

Q&A

Roundtable discussions:
Valuation risk
Board Effectiveness

John Griffin
Leader, US Asset Management Governance, PwC

David Trerice
Assurance Partner, Asset Management Practice, PwC

Accounting and Tax Update

Annette Spicker
Assurance Partner, Asset Management Practice, PwC

Ryan Folscroft
Senior Manager, Asset Management Practice, PwC

Karen Visco
Tax Partner, Asset Management Practice, PwC

Agenda - Current accounting developments

- Investment company project
- Consolidation
- Liquidity and interest rate disclosures
- Revenue recognition
- Balance sheet netting

Investment company project

Investment companies

Background and overview

- Investment companies are exempt from applying normal consolidation guidance to their portfolio investments and measure all investments at fair value under US GAAP
- Current guidance is not convergent
  - US GAAP already defines investment companies and provides specific accounting guidance and disclosures for such entities
  - A similar definition of investment companies and exception from consolidation does not exist in current IFRS
- The IASB and FASB issued proposals for a new definition in 2011; they also obtained feedback from roundtable meetings and other outreach to constituents
- The boards have completed the joint portion of the redeliberations and have decided to move to a principles-based approach consisting of a definition and additional factors to consider in order to assess if an entity is an investment company
- Effective date for FASB TBD; the IASB has decided on a January 1, 2014 effective date with early adoption allowed

Investment companies

Key differences between FASB and IASB approaches

- The FASB requires entities subject to the Investment Company Act of 1940 to qualify as investment companies whether they meet the definition or not
- Unlike the IASB, FASB retains specialized investment company accounting on consolidation by a non investment company parent
- While both the FASB and IASB preclude investment companies from consolidating other non investment companies which they control, the FASB has decided to retain current practice regarding consolidation of investee funds
- The FASB requires feeder funds to attach master fund financial statements in a master-feeder fund structure. The IASB does not have the same requirement
- Other financial statement presentation and disclosure requirements differ

Consolidation

Consolidation
Principal versus agent analysis

Background and overview

- In response to significant concern about unintended consequences of amendments to the VIE model (FAS 167) for asset managers, FASB temporarily deferred application of those amendments to certain investment entities
- FASB issued a proposal in late 2011 that aimed to eliminate the deferral by introducing a qualitative approach for assessing whether the party with power over a VIE is using that power in a principal or agent capacity
  - If an agent then the party would not consolidate, if a principal then the party would consolidate
  - The analysis would focus on three key factors: (1) the rights held by other parties (2) compensation (3) exposure to variability from other interests
- The consolidation model for partnerships (that are not VIEs) would also be aligned by requiring the same principal versus agent analysis
- The effective date of the proposal is still to be determined

Consolidation
Principal versus agent analysis

Current status

- In May 2012 (in response to the comment letter feedback), FASB decided to redeliberate most aspects of its proposal, including:
  - Consolidation conclusions for money-market funds, securitization and asset-backed financing entities, and for entities previously considered qualifying special-purpose entities
  - Application of consolidation guidance to partnerships and similar entities
  - The overall principal versus agent analysis, including the factors to be considered in that assessment and how these factors should be weighted
  - The role of kick-out, participating, and redemption rights, and the manner in which related parties are considered in the consolidation analysis
- Redeliberations on the above items have begun and will continue over the remainder of the year, with the aim of issuing a final standard in the first half of 2013
  - FASB confirmed the definition of participating interests would be aligned between the VIE and voting interest models, thereby potentially changing consolidation conclusions for some voting entities

Liquidity and interest rate risk disclosures

Overview of proposal

- Standard developed under the premise that users feel disclosures concerning an entity's liquidity risk and interest rate risk need to be improved
- Footnote disclosures in tabular form
  - **Liquidity** risk disclosures
    - Focus is an entity's ability to meet its financial obligations
    - Required for all entities and consists of two tables – available liquid funds table and either expected cash-flow obligations table (non FI) or expected maturity table (FI)
    - Time deposits table for those who take deposits
  - **Interest rate** risk disclosures
    - Only for Financial Institutions
    - Focus is on asset/liability matching and interest rate sensitivity analysis
    - Consists of two tables – repricing analysis table, interest rate sensitivity table
  - **Timing**
    - FASB exposure draft issued June 27, 2012 and comment letters were due September 25, 2012

Overview of proposal

- **Liquidity** risk disclosures apply to **all entities**
- **Interest rate** risk disclosures only apply to *Financial Institutions* as **defined**
  - ***Financial Institutions*** defined in the standard as those engaging in activities with the intent of earning its primary source of income from managing the difference between returns received on its financial assets and those paid on its financial liabilities (**spread business**)
    - However, entities that carry substantially all of assets at FV-NI or primary business is a service business (i.e. broker dealers, investment companies, investment banks) will **not** included in definition of *Financial Institutions*
    - **Additionally** it would include those **entities that provide insurance** even though primary business is not to earn a spread (i.e. short duration property casualty insurers)
    - Also includes **reporting segments** that are involved in lending to or financing the activities of others

Required quantitative disclosures

Liquidity risks

Two tables required

- All entities
  - **Available liquid funds table**
    - Includes unencumbered cash and high-quality liquid assets, and borrowing availability such as lines of credit
    - Discuss the effect of regulatory, tax, legal, and other restrictions that could limit the transferability of funds among entities in the consolidated group
- Non-financial institutions
  - **Expected cash-flow obligations table**
    - Undiscounted
    - Includes all financial liabilities, including lease obligations and off-balance-sheet obligations

Required quantitative disclosures

Liquidity risks (cont.)

- Financial institutions
  - **Expected maturity table**
    - Use contractual settlement not expected timing of sales i.e. if instrument is prepayable within the contract terms then need to make assumptions about expected contractual maturity
    - Instruments at FV-NI (with the exception of derivatives) would not be placed in maturity buckets and would only show the total carrying amount (that reconciles to the balance sheet)
    - Table includes insurance liabilities and off-balance-sheet commitments, for example, loan commitments and lines of credit
  - Additionally Financial Institutions that are also Depository Institutions (not per se defined)
  - **Time deposits table**
    - Shows issuance of time deposits (insured, uninsured, and brokered deposits) during the last four quarters, including the average rate and average life

Required quantitative disclosures

Interest rate risk

Only for FI, two tables required

- Financial Institutions
  - **Repricing analysis table**
    - Shows when classes of financial assets and financial liabilities would reprice (interest rate would be reset) for those that are interest-bearing and also shows non-interest bearing
    - Also includes weighted-average yield (interest-bearing instruments only) and duration of classes of assets and liabilities (all instruments)
  - **Interest rate sensitivity table**
    - The effect of prospective, hypothetical interest rate shifts on the entity's interest-sensitive financial assets and liabilities
    - Shows the effect of parallel shifts, flatteners, and steepeners of the curve
    - Excludes the effects of certain assumptions such as a company's strategy related to assumed growth rate or change in asset mix

Revenue recognition

An update on the joint FASB/IASB revenue recognition project

- Re-exposed in Q4 of 2011
- Comments were due on March 13, 2012
- Core model is generally consistent with the 2010 ED
- Proposed standard would not be effective earlier than for annual reporting periods beginning on or after January 1, 2015
- The proposal will impact the following 3 streams of revenue for an asset manager
  - Asset based fees, most commonly advisory fees
  - Performance fees
  - Upfront distribution fees
- Proposal also covers costs that may be capitalized in obtaining or fulfilling a customer contract
  - Will overwrite the industry specific guidance for capitalization of "back-end" loads classes

Revenue recognition

Asset based and performance fees

- The re-exposure addresses major industry concerns raised last year
  - Initial draft would have caused asset based fees to be deferred over time
- Asset based fees
  - Record asset based fees when billed
  - No significant change vs. current accounting
- Performance Fees
  - Revenue recorded at end or near of performance period.
  - Proposal essentially eliminates “Method 2”
  - “Reasonably assured” threshold difficult to meet
  - Susceptibility to market movements and long time horizons

Revenue recognition

Upfront fees-front-end loaded

- Commission/sales charge paid by the investor
  - Compensates the fund distributor (can be affiliate of advisor)
- Today the commission is recorded as revenue at the time of the trade by the distributor
- Proposed model may lead to new pattern of recognition
  - Who is the customer-the fund or the shareholder?
  - Is the distribution service distinct from other services provided to the fund-advisory, shareholder servicing, etc.

Upfront fees-capitalization of costs

- Proposal allows capitalization of incremental costs “to obtain a customer contract”
  - Cannot capitalize costs to fulfil a contract if performance is complete
- If customer is the shareholder then any incremental costs to obtain the contract may be capitalized (i.e. Commissions paid to the brokers, bonuses to sales force)
- If customer is the fund then there are no costs to capitalize

Balance sheet netting

Balance sheet netting

- In December 2011, ASU 2011-11, **Disclosures about Offsetting Assets and Liabilities**, was issued
- Requires new disclosures to help reconcile differences in the offsetting requirements under US GAAP and IFRS, which continue to be significant for certain entities
- Includes an exception that will continue to permit netting of derivatives, repurchase agreements, and related collateral subject to master netting agreements under US GAAP, provided certain conditions are met
- No similar exception is included under IFRS
- Effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods

Balance sheet netting
New disclosure requirements

- The following information for assets and liabilities within the scope of the new standard will be required:
  a. The gross amounts of those recognized assets and those recognized liabilities
  b. The amounts offset to determine the net amounts presented in the statement of financial position
  c. The net amounts presented in the statement of financial position
  d. The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in (b)
  e. The net amount after deducting the amounts in (d) from the amounts in (c)
- New requirements exclude loans and customer deposits at the same institution (unless they are offset in the statement of financial position) and financial instruments that are only subject to a collateral agreement
- Flexibility about how certain items are disclosed is permitted. For example, companies can choose to disclose items (c) through (e) above either by class of financial instrument or by counterparty

SEC update

- Organization, staffing and budget
- Agenda items
- Enforcement
- Comment letter process

SEC comment letter themes

AUM

- Disclosure of AUM by Level 1, 2 & 3
- Disclosure of AUM that is concentrated in sovereign debt
- Does AUM contain money market funds sponsored by the registrant

Fee rates

- Discussion regarding the impact of different fee rates on revenue
- Discussion of average fees or range of fees by asset class

Pricing services

- SEC focus is on the use of pricing services—especially around level 2 investments
- Focus has been on the process and controls in place around use of pricing services

Refer to Appendix A for example comment letters on the various topics.

SEC comment letter themes
Other areas of interest

- Income taxes
  - Permanent reinvestment
  - Foreign earnings
- MD&A (liquidity)
  - Impact of covenants on access to debt/facilities
- Goodwill
- Commitments & contingencies
- Non-GAAP metrics

PCAOB standard on communications with audit committees

- Goal of enhancing the relevance and quality of communications between auditors and audit committees
- Communication requirements include areas such as accounting policies, critical estimates, quality of financial reporting, and significant unusual transactions
- Many of the communications are linked to the results of the audit procedures or the conduct of the audit, such as nature and extent of specialized skill or knowledge needed in the audit and difficult or contentious matters for which the auditor consulted outside the engagement team

Agenda - Tax update

- Tax legislation update
- RIC Modernization Act – Selected excise 2012 considerations
- Other hot tax topics

Tax legislation update

- Sunset of Bush-era individual tax cuts and other tax extenders
  - Uncertainty
  - Will provisions be extended? In whole or in part?
- Factors influencing outcome
  - Federal government budget deficits
  - “Fiscal Cliff”
  - November Election
- Timing of Congressional action
  - Lame duck session …. or later

Tax legislation update

Which expired or expiring tax provisions are of most interest to investment funds and investors?

- Observations –
  - Reduced marginal individual income tax rates
  - Reduced individual income tax rates applicable to –
    - Net capital gain
    - Qualified dividend income
  - Interest-related dividends
  - Short-term capital gain dividends

Tax legislation update

What would the 2013 tax rates on investment income be if the Bush-era tax rates expire on December 31, 2012?

- Observations –
  - Tax rates on investment income would increase – dramatically in some cases
  - New Medicare health insurance surtax on certain net investment income would also apply in 2013

Tax legislation update
Outlook for top individual tax rates

	Wage income	Interest income	Dividends	Capital gains
2012 top rate	36.45%*	35.0%	15.0%	15.0%
2001/2003 tax cut expiration**	+4.6%	+4.6%	+24.6%	+5.0%
2013 phase-out of itemized deductions	+1.2%	+1.2%	+1.2%	+1.2%
2013 HI surtax	+0.9%	+3.8%	+3.8%	+3.8%
Total increase in rate	**+6.7%**	**+9.6%**	**+29.6%**	**+10.0%**
2013 top rate	**43.15%**	**44.6%**	**44.6%**	**25.0%**

* Includes 1.45% current law employee share of Medicare HI tax (additional 1.45% applies for self-employed)
** Assumes expiration of 2001/2003 tax cuts after 2012

Tax legislation update

Looking forward to 2013, what are the prospects for significant tax reform legislation next year?

- Observations –
  - Policy considerations –
    - Reducing the deficit
    - Stimulating economic growth
  - Reform proposals
    - President Obama
    - Governor Romney
    - Congress

Comparison of tax reform proposals

Proposal	Fiscal Commission	House Republicans	Wyden – Coats	President Obama	Governor Romney
Individuals	12%, 22%, and 28%	10% and 25%	Three brackets: 15%, 25%, and 35%	10%, 15%, 25%, 28%, 33%, 36%, and 39.6%	8%, 12%, 20%, 22.4%, 26.4% and 28%
Corporations	28% top rate	25% top rate	24% top rate	28% top rate	25% top rate
Capital gains and dividends	Tax at ordinary income rates	15% top rate	Tax at ordinary income rates with 35% exclusion	20% top rate (capital gains); ordinary rates (dividends)	15% top rate and eliminate taxes for individuals with incomes below $200,000
AMT	Repeal	Repeal	Repeal	Repeal	Repeal
Domestic production deduction	Repeal	To be determined	Repeal	Target and increase deduction to 10.7% (18% for advanced manufacturing)	To be determined
R&E	5-year amortization	To be determined	Present law	Make R&D credit permanent and increase ASC	To be determined
Cost recovery	Repeal accelerated depreciation	To be determined	Expensing	Address depreciation schedules	To be determined
International	Territorial	Territorial	Repeal deferral	Minimum ETR on foreign earnings	Territorial

RIC Modernization Act
Selected excise 2012 considerations

Initial year implementation observations

- Modification but not simplification
- Computation challenges
  - Application of new rules in calculation templates
- Technical challenges
  - Interpretation of new rules
- Evolving perspectives on new rules
  - Deferral decisions on excise/fiscal coordination rules

Other hot topics

- Commodity funds
- European union tax reclaims
- Other

Appendix

Appendix A – SEC comment letter examples

AUM by level

"We continue to believe that you should revise your disclosure to include the total dollar value or percentage of assets under management for which the overall value is measured based on Level I, Level II and Level III for each period presented. We note that your revenue recognition is driven by the valuation of your assets under management. Given that this is a critical estimate, we continue to believe that this additional quantified disclosure should be provided so that investors can better understand the underlying nature of your assets under management and the potential subjectivity of their valuation."

"Please also provide fair value level disclosures as of _____. In addition, if the fair value level disclosures as of each balance sheet date are not representative of the fair value levels during the periods, please address that fact."

AUM exposure to sovereign debt

"Quantify the amounts of assets under management that are concentrated in sovereign and non-sovereign debt exposures in European countries of concern. Explain how changes in these amounts impacted your results, and address the potential impact, risks and uncertainties that may be associated with future changes. Please provide your analysis separately for each European country for which you have significant AUM related to sovereign and non-sovereign debt."

Appendix A – SEC comment letter examples

AUM & money markets

"Help us understand whether your assets under management contain money market funds that you sponsor. Tell us what consideration you have given to the possibility of supporting such funds in the event of a decline in the value of their net assets."

Fee rates

"Provide us with a specific and comprehensive quantified discussion regarding how changes in the composition of assets under management impact your results. In this regard, we note your revenue is impacted by different fee rates. To the extent average fees or the range of fee rates differs based upon asset class; please revise future filings to discuss the differences and how changes in asset class concentrations impact results."

Appendix A – SEC comment letter examples

Pricing services

"Please describe to us in detail the following: how you evaluate the accuracy and completeness of the observable inputs used by such pricing services in valuing securities; the internal controls in place to ensure that models and assumptions used by pricing services reflect those used by market participants; and the internal controls you have in place over the prices received from pricing services."

"Explain the frequency of independent auditor reports that you receive regarding the internal controls at pricing services. Explain what you do when these reports do not cover an entire financial reporting period. Explain which securities these report(s) relate to and what controls are in place for those security types for which auditor reports are not available. Describe to us any control deficiencies identified related to the service provider's valuation of Level 2 securities and how you considered the deficiencies in concluding you have complied with GAAP relating to valuation and have effective internal control over financial reporting (ICFR)."

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