August 2010

Thoughts from the boardroom

A frank discussion

The discussion flowed into three major areas of interest:

- Risk management
- 15(c) contract review considerations including investment performance
- Industry consolidation resulting in expanded responsibilities of the board

PricewaterhouseCoopers recently played host to directors of major mutual fund boards for a roundtable discussion of their perspectives on current issues in the industry with respect to mutual fund board duties and responsibilities. The relaxed and frank discussion offered a window into the board-level thinking, particularly in light of the existing market volatility.

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Risk management

Perhaps more than any single subject, risk management—and how best to practice it—pervaded the roundtable.

- **Who owns risk?** Some boards are pushing the chief compliance officer (CCO) to do more with risk management. Specificity regarding one's role in risk management is important because of the expense and compensation attached to increasing staff for risk management efforts. At the same time, the directors agreed that risk management must extend beyond the CCO or a single committee. Companies should embed it into every aspect of operations, with risk on the agenda for every board and committee meeting.

  Yet, the industry continues to struggle with a lack of best practices and robust benchmarks to guide companies and their boards.

  Some directors expressed their view that firms with CEOs who take a personal interest in the specifics of risk give their firms an advantage over others. A few directors noted that many of the firms that escaped the 2008 financial crisis relatively unscathed had CEOs who personally understood risk and made management decisions accordingly.

- **Understanding new investment products**: Some directors noted that they face challenges in understanding complex investment instruments—particularly derivatives—that portfolio managers and firm management propose in connection with the innovation and launch of new products. The level of information provided to the directors differs across boards, with some companies supplying regular reports on the types of derivatives used for investment and at other companies; directors need to ask for more information. Boards need to fully understand both the risks and potential returns of the products. Further, the directors also need to understand how management will address those risks as well as how they will keep the directors informed.

Some noted that boards may stop their funds from investing in certain types of derivatives such as credit default swaps until they have enough information and understanding of the risks. Even with that information, one said that it may be unrealistic for each member of a board to fully grasp the implications of derivatives and other complex instruments. The hope, rather, is that each board member will bring unique expertise that other board members can rely on for specific products. It is not necessary for every director to understand every investment; but it is necessary for at least one director to fully understand the various risks involved.

PwC point-of-view

What does it mean to practice adequate risk management? Which investment vehicles contain unacceptable risk? Are risks fully disclosed to shareholders? In seeking to fulfill their fiduciary duty to fund shareholders, are directors asking the right questions? The challenge directors face is defining the scope of their role and being able to recognize when they have done enough to satisfy their fiduciary duty. In the industry as a whole, some directors are wondering if they are performing their risk oversight duties as fully as expected, while others may be going above and beyond; however, in the absence of objective industry standards it is difficult for a director—or others—to know if he/she is doing enough. Directors will benefit from learning about various boards' fiduciary oversight practices. While we do not advocate a "check the box" mentality, we view the development of industry fiduciary standards as an improvement in the governance of mutual funds.

The SEC's new proxy disclosure rules, effective February 28, 2010, are intended to improve shareholder and investor understanding of the board's role in risk oversight, including how it interacts with management. These rules clearly highlight the need for a re-energized focus on risk. Boards are struggling to align their oversight roles with program execution practices of management and are finding it

increasingly challenging to balance their fiduciary and oversight roles within the organization.

PwC believes the following points should be considered by directors as they fulfill their fiduciary roles surrounding risk management oversight:

1) Whether all material risks related to the funds are fully understood;
2) The extent to which service providers impact those risks;
3) The process to periodically validate risk management practices and oversight;
4) The tone at the top and expectations for fund risk management practices;
5) The process to identify emerging risks and trends;
6) The quality of the data underlying risk management and oversight reporting;
7) Whether all risk management and oversight resources have been utilized and considered;
8) Whether conflicts of interests have been assessed in risk management and oversight practices;
9) The level and detail of documentation supporting risk management and oversight matters; and
10) The extent and utility of self-assessment reviews.

PwC's relationships with fund directors provide us a wide view of industry practices. Working with boards we can help benchmark existing frameworks to assist board members in understanding how their oversight duties compare to others. The general approach the board should consider is to understand and evaluate management's approach to (1) risk identification and prioritization, (2) assessment of business practices and related controls to manage risk, and (3) understand and evaluate management's monitoring, escalation and reporting practices. Finally, consideration of these factors should help the board in their own self-assessment of monitoring compliance with the new SEC disclosure requirements regarding how the board is fulfilling their fiduciary duty to shareholders in overseeing risk.

15(c) contract review considerations including investment performance

Evaluation of the management contract with the advisor, including the fund's performance, is perhaps the most fundamental duty assigned to mutual fund directors. Yet, several of the directors noted the increasing difficulty of measuring performance in a time when factors like long-term risk profile and fee structure have become increasingly important considerations in judging a fund's performance.

The discussion focused on several aspects of the 15(c) contract review process and how new developments are affecting it:

- **Investment performance**: Several directors discussed the ever-present tension between short-term measurement and longer-term strategy in assessing fund performance. A year-to-year measure as opposed to a rolling average may be a preferable measurement of success to some because a single excessively good or bad year can distort a multi-year average. Some also noted the need to understand the particular strategy and market impacts on performance.

  It was noted that striking a balance between patience and accountability can be subjective. The directors remarked that their boards do not have clear performance benchmarks that portfolio managers must meet. Some felt that establishing better defined parameters regarding actual performance relative to the benchmark would be helpful.

  Generally, it appears there is an element of patience in evaluations of portfolio managers, particularly if their investment decisions conform to management's overall strategy. But that instinct can run up against shareholder impatience. And at least one director felt the need to exert more influence on portfolio manager tenure when investment performance is not sustainable.

- **Profitability and economies of scale**: There tends to be a lack of benchmarking or accepted standards concerning the evaluation criteria of advisor profitability and economies of scale. The range of profitability reported in aggregate by fund varies, and some indicated that firms may be aiming for profitability targets consistent with peer groups rather than seeking to reduce costs as much as possible. Some directors are asking for more dialogue about the methodologies applied in the profitability analysis and the advisor's re-investment of profits.

  Many firms seek economies of scale for fund support services. Consolidation may facilitate this process. However, a few directors noted that some funds are so specialized that the shared services model doesn't work well. The consensus is that boards need to do more to ensure that economies of scale are benefiting shareholders, but it is difficult to quantify how exactly to do this. Directors are looking for more direction regarding how to quantify and share cost benefits achieved from economies of scale. Similarly, there are views that fund companies should have a consistent philosophy about how to think about breakpoint pricing in particular those undergoing mergers and acquisitions. It was noted that there may not be full understanding of why breakpoint pricing can be more aggressive on one platform when compared to another.

- **Jones v. Harris**: In Jones v. Harris Associates, a recent case addressing claims that a mutual fund adviser charged excessive fees, the Supreme Court's decision concerning the fiduciary responsibility of investment advisors is not expected to have extensive impact on the contract review process. The decision applies the requirements of a

previous decision, known as the Gartenberg case to investment advisors. Although no significant changes to the process are expected, directors are interested in creating more dialogue about transparency and fee structure. In the current economic climate, if an advisor's profits increase, some directors commented that it would be difficult to explain how/why increased profits are not going to shareholders.

Several board members said they are either required or strongly encouraged to invest in the funds they oversee, which demonstrates an alignment of the board member's and shareholder interests, and is also related to questions about what portion of a board member's compensation should be in the form of fund shares and deferred compensation.

PwC point-of-view

Most fund boards perform established procedures to satisfy Section 15(c) requirements of the Investment Company Act of 1940, which requires trustees to annually review the contracts with the investment advisor, and to request "such information as may reasonably be necessary" to evaluate the terms of the contract. The Supreme Court's upholding of the prevailing Gartenberg standard means that the mutual fund industry can continue to build upon the standard, which will be helpful to both advisers and independent boards in their annual contract review process. With respect to the boards evaluation of the fund's investment performance, business judgment is necessary to evaluate overall service quality on both a short-term relative basis as well as a longer term view.

Boards have been questioning whether they have been doing enough to ensure that economies of scale are fully and appropriately reflected in the costs borne by shareholders. Boards should re-assess their funds' fee schedules and ensure they are consistent with what the board sees as a cohesive pricing philosophy. Some points to consider include the use of appropriate breakpoint pricing, either at a fund or group level, the use of voluntary expense waivers and caps, and the use of qualitative and quantitative analysis to explore the relationships between changes in assets under management over a period of time, and the advisor's functional costs, and profitability trends. Boards should also consider the fund's pricing and related service model to other similar managed accounts (e.g. separate accounts, pension assets).

Industry consolidation resulting in expanded responsibilities of the board

Several of the directors said they have focused much of their time and effort on discussing and approving mergers of fund families as a result of recent acquisitions at the advisor or parent company level. There are several challenges to consider, starting with the sheer number of funds coming under the fiduciary responsibilities of the directors. In some cases advisor acquisitions in the industry are doubling the number of funds in the fund family and significantly increasing the size of the boards overseeing them.

Beyond the raw numbers, the investment focus and fee structure of funds often varies significantly between fund companies. This consolidation pattern also highlights an ongoing question within the industry over outsourcing of services. As firms merge, they are re-examining the models they use (internal versus external), and what service provider changes will be made.

PwC point-of-view

Industry consolidation can lead to redundant product offerings, causing boards to choose product rationalization/fund mergers where appropriate. Additionally the post-consolidation organization will have duplicate resources in some, if not many, areas, causing management and boards to make important and often delicate decisions regarding how to cut back resources without losing effectiveness or institutional knowledge. Boards should use this opportunity to assess the overall operational structure of the organization, including revisiting decisions on outsourcing and in-sourcing. Of course, any considerations of resource reductions or operational changes must assume that the fund continues to operate in full compliance with fiduciary standards, legal requirements, and consistent with shareholder expectations.

Consolidation also impacts boards, which means that boards should use a consolidation as an opportunity to assess some of the key issues of board's composition and operation, including board compensation, succession planning, and on-boarding.

Closing thoughts

Based on the candid dialogue at this round table, it is evident that directors have a great deal to think about in the current changing economic environment. The key themes that emerged, as discussed above, are clearly challenging and do not come with easy answers. Open and frank discussions with management and other directors, as well as reaching out to industry experts, can assist in facing these challenges.

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