

The 2008 Mutual Fund Governance Survey*

Executive Summary



*connectedthinking

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Introduction

First came sub-prime, then banks started to collapse and the entire financial system seemed to go crazy, now Madoff reveals to the world how simple it is to ruin thousands of investors... Investment funds, whether private or retail, have by no means been spared by the consequences of these shortfalls. Could they have been avoided in any way through a truly sound corporate governance?

It is with this question in mind that PricewaterhouseCoopers Luxembourg has presented, on December 15, 2008, its 4th edition of the Mutual Fund Governance Survey, a survey initiated in July 2008, before the Lehman collapse and subsequent financial crisis. 19 asset managers from 10 different nationalities were questioned and their responses (21 in total) all related to UCITS III-compliant funds, largely distributed throughout the world (21 countries on average). Compared to previous editions of the survey, the 2008 one aimed to focus on distribution issues and their review by the Board as well as Board reactions facing the sub-prime crisis.

The Luxembourg fund governance model

The Luxembourg model is characterised by the co-existence of different structures (self-managed SICAVs, SICAVs with a designated management company, contractual funds (FCPs) with a management company), and the responses to the survey were unsurprisingly varied. While it is quite easy for a Board of a SIAG to respond in its capacity of “governing body” of that SIAG, the same is not true for the Board of a SICAV which has designated a management company, especially if that management company is in-house: while, strictly speaking, the governing body of that SICAV is still its own Board of Directors, 6 respondents to the survey chose to respond as management company representatives, as if there had been a complete shift of roles and responsibility to that latter entity. This being said, 5 others took an entirely different stance and responded in their capacity of members of the SICAV Board, even if that SICAV has designated a management company.

This apparent inconsistency only shows that in many people’s mind in Luxembourg, the organisation of a fund’s governance remains unclear. The split of roles and responsibilities between the SICAVs Board, on the one hand and its management company, on the other, and that of the Board and/or the dirigeant of that management company, is not fully understood. Similarly, 3 respondents indicated that they don’t know their legal liability as a Board member. 25% of respondents do not know how their role as Board member differs from that of the “dirigeant”.

The classic topics

Board meeting organisation

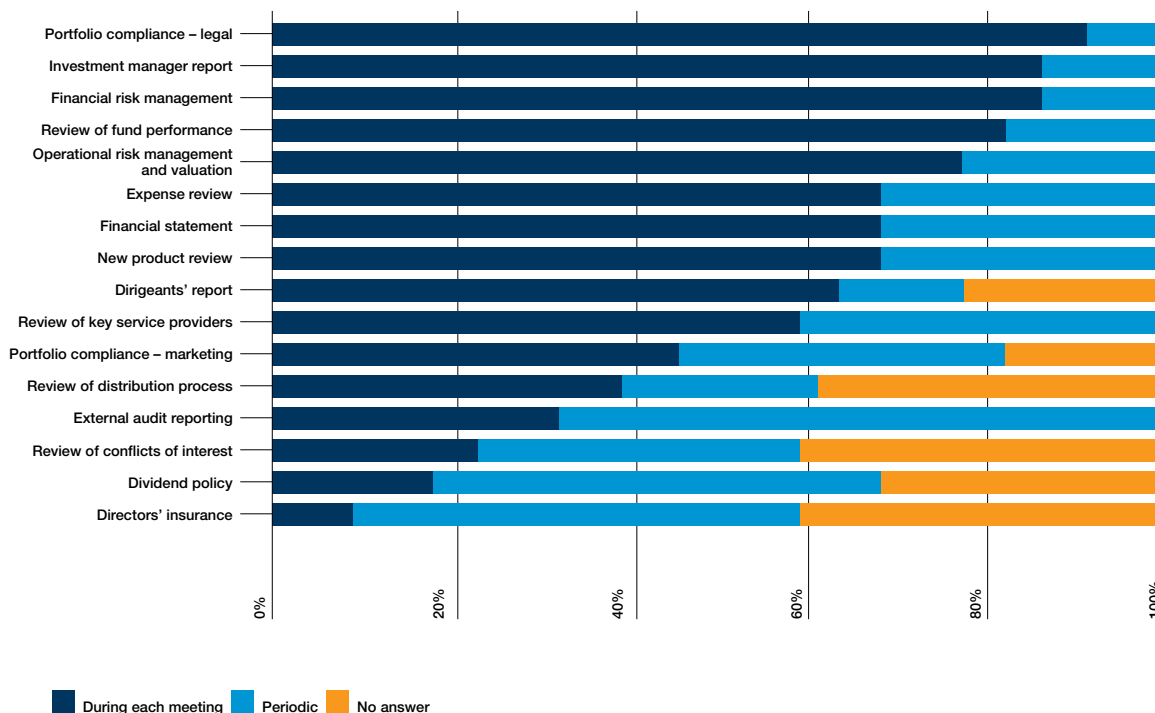
On average, 4 Board meetings are held per year and members need 6 hours to prepare them. All respondents to the survey indicated they receive a well prepared board pack prior to the meeting, which lasts in average 3.6 hours. The standard agenda items remain, as in previous editions of the survey, financial figures, risk management reports, portfolio compliance reviews and fund performance. Most of this information is prepared in-house; independent reviews are occasionally used by 57% of the participants.

Standard issues on the agenda

Information received to prepare the meeting

- As a standard (100%): financial figures, RM reports, compliance.
- 90% of respondents receive as a standard legal updates, fund sales statistics.
- Occasionally, only do Boards receive independent or third party reviews (57%) or competitor info (62%).

Information reviewed during the meeting



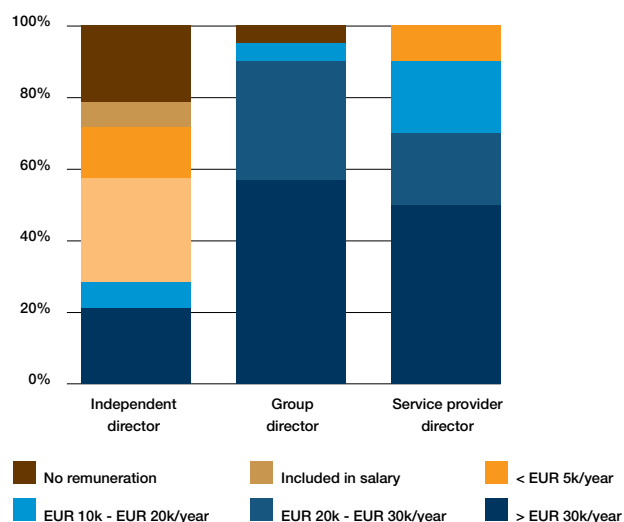
Who are the Board members?

Board members are still, in majority, representatives of the promoter. The experience of Board members remains at a reasonably high level, at least in terms of number of years in the job: 37 % of respondents had Board members with a job tenure of over 5 years, 49% of them were in the job between 1 to 5 years.

The proportion of “independent” Board members, this term still not being very clear in everyone’s mind, has slightly grown between 2006 and 2008: 62% of respondents have independent Board members (55% in 2006). The independent portion represents a third of the full Board, i.e. in a classic fund board with 3 directors, one, generally sourced from a professional firm (lawyer) or from the industry, is independent.

Board members’ benefits and support

Remuneration



Other benefits

Liability Protection

- 48% are covered by both insurance and indemnification.
- 19% have no protection at all.

Board member support

- 76% have been explained what their tasks as directors would be.
- 33% of respondents have a process in place for information and education.
- Training is still poor: 71% receive no training at all or less than 1 day/year.
- Only 29% have more than 1 day of training/year.

Being a Board member undoubtedly brings certain risks with it, which would warrant some financial compensation as well as a liability protection. However, one notes that group directors seldom receive a compensation for their directorship and even independent directors are relatively poorly paid, notably in comparison with 2006, where out of the respondents surveyed at the time, 50% indicated that their independent directors were paid over EUR 20K a year – this proportion is now at less than 30%. This contradicts what we see on the market, however, and is probably more reflective of different respondents than a concrete trend.

Surprisingly in the current environment, liability protection is still not obtained by all: while almost 50% had both insurance and an indemnification clause from the promoter, 19% had no protection at all.

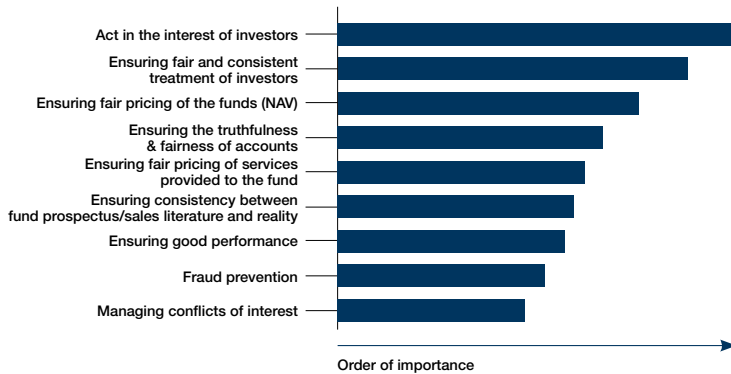
Finally, Board support tends to be reasonably satisfactory, save for training: only 29% of respondents, i.e. less than one third, received one day or more of training a year. This leaves us with 71% who have no other means than personal training and day to day experience to stay abreast of the numerous, complex and rapid evolution this industry is facing.

Roles and responsibilities

Fiduciary responsibility

How do Board members see their roles ?

What constitutes the fiduciary role of the Board?



Conflicts of interest

- For 85% of respondents, managing conflicts of interests is a key role of the Board.
- 52% of them have already identified potential conflicts, in most cases through an independent exercise at Board level.
- Those that identify also know how to manage them.

While all respondents agree that the Board must act in the best interest of investors, the bar chart shows that all topics listed therein are not of equal importance. The question of conflicts of interests, for example, does not rank very high. While 85% of respondents believe the management of those conflicts is a key role of the board, only 52% have gone as far as identifying conflicts in their organisation.

Some examples of such conflicts were: “*Compensation of independent directors*”, “*Performance of the fund vs. increasing costs and demands*”, “*Conflict between being a member of the SICAV Board and of the management company*”.

Management style

As it was already the case in 2006, the vast majority (95%) of respondents use a management style characterised by “oversight and management by exception”. Certain management decisions, which go very much in the day to day, detailed functioning of a fund, are, however, taken by the Board and not just left to the “dirigeants”: adoption of risk management methods, classification of funds, creation of new products, entering new markets, etc... This being said, a few respondents clearly indicated that their Board is less a decision-making and more a ratifying body of decisions made elsewhere in the group. This is notably the case when it comes to termination of service providers, with only 74% of the Boards even taking the formal decision to terminate, and 26% leaving this decision to others!

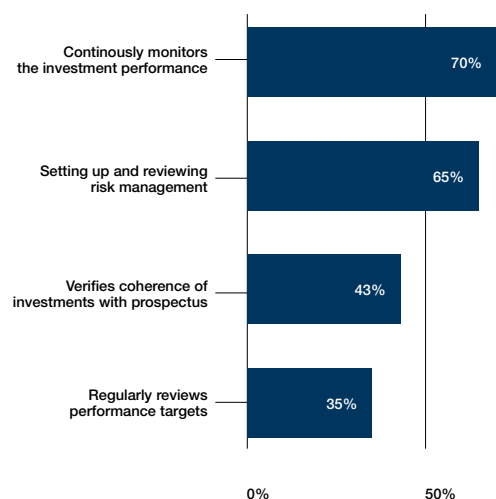
Relationships with the dirigeants have now apparently found their place in the UCITS III world, with almost 40% of respondents seeing a daily interaction between Board and dirigeants and another 40% a monthly one. Slightly more concerning, however, is the fact that up to 25% of respondents still do not know the difference, in terms of roles and responsibility, between a dirigeant and a Board member...

Fund performance

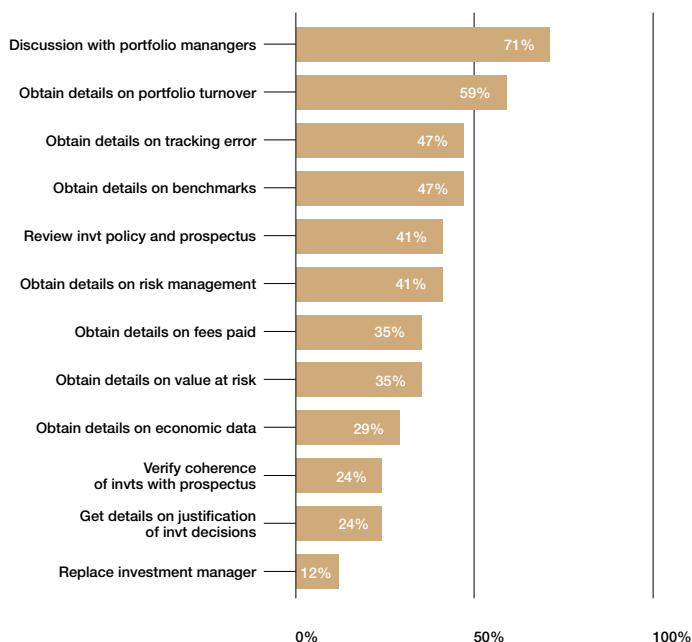
The activities of the Board regarding fund performance are relatively standard and have not changed very much since the date of our last survey.

Board activities regarding fund performance

Primary functions regarding fund performance



Actions taken in case of underperformance



Similar to what was noted earlier, where certain fund Boards indicated not always being the decision maker, 32% of respondents also noted that their fund Board was not particularly involved in the performance review, leaving this to centralised departments within the group.

The use of VaR tends to spread, with 48% of respondents indicating that they have increased their use of this risk and performance measurement method over the past 2 years and 62% thinking that it will increase even more in the future. As for other matters, certain Boards do not think they are sufficiently trained in VaR techniques (in 26% of cases).

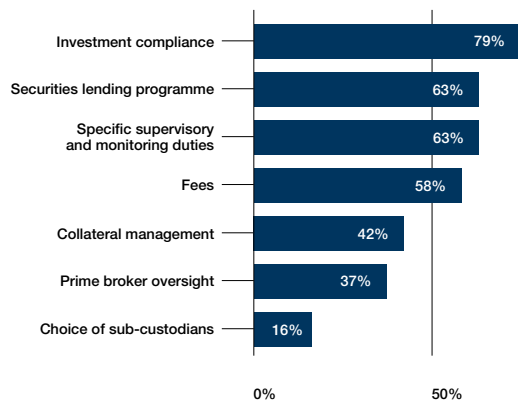
Selection and review of service providers

The services reviewed by the funds' Boards are relatively standard – it is quite interesting to note, in the current Madoff context, that only 16% of funds review or ask information regarding the custodian's sub-custody network: this will probably change in the coming months.

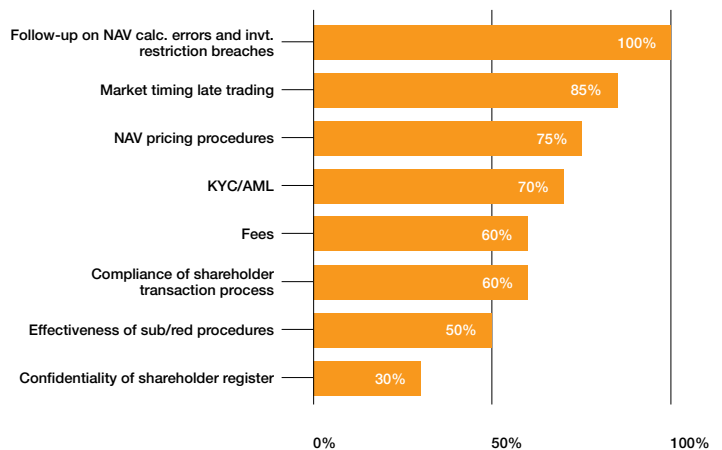
As confirmed in the special section of the survey focusing on distribution, the qualitative review of distributors and notably of their selling methods and materials, remains very light and is often not done by the Board at all.

Review of service providers – Which of the following issues are being reviewed on a regular basis?

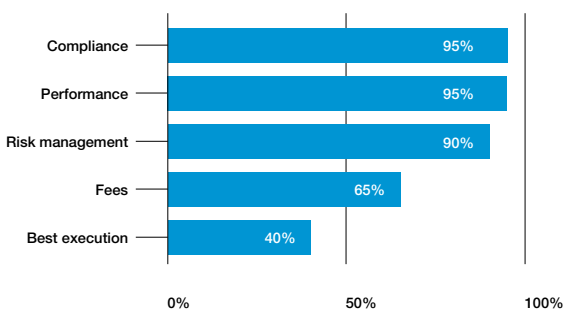
Custodian



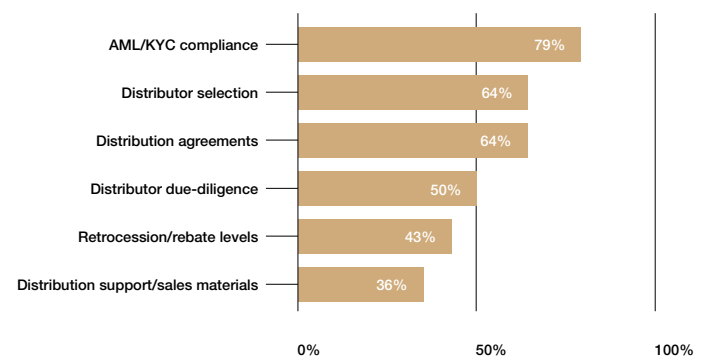
Central administration



Investment manager



Distributor



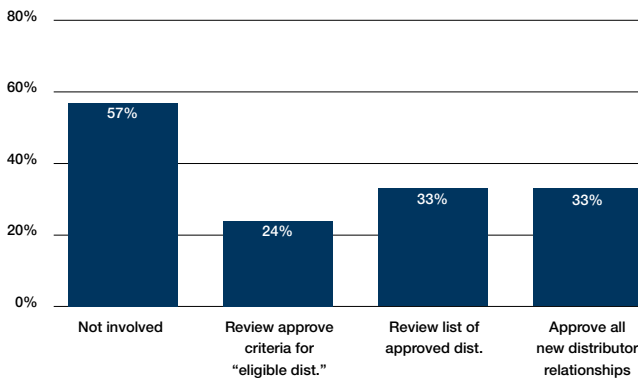
Focus on distribution

This section was created to get a better view on the Board’s involvement in the distribution process, which is often not at the heart of an asset manager’s business.

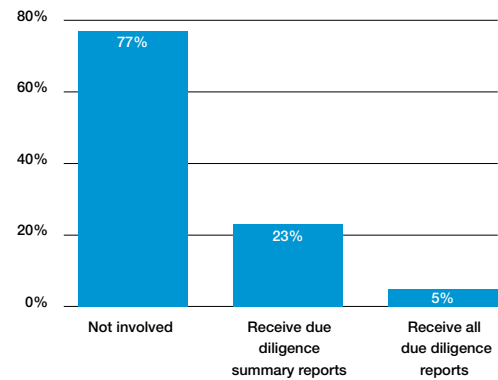
In general, Board review and implication of the distribution process remains light.

Board implication in the distribution process

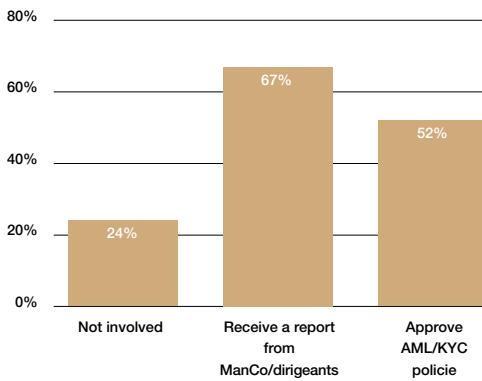
Distributors selection



Distributors due dilligence



AML/KYC compliance



Save for AML/KYC related issues, Boards are not very involved in the distributor choice.

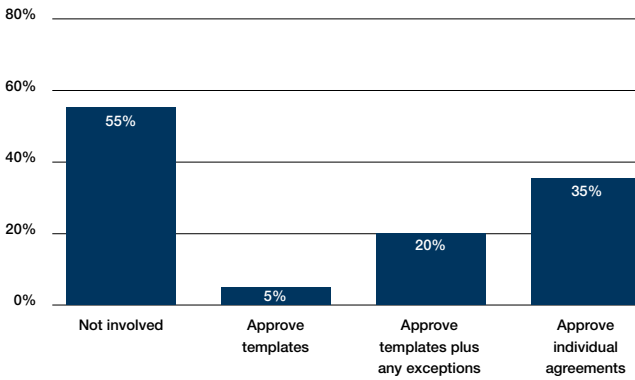
One of the very basic questions we wanted to address was the acquaintance of fund boards with the MiFID in general and its impact on their distributors, in particular.

Almost 40% of respondents do not have a clear view on the MiFID or non-MiFID status of their distributors. Only 17% make a distinction, in their board oversight, between MiFID and non-MiFID distributors.

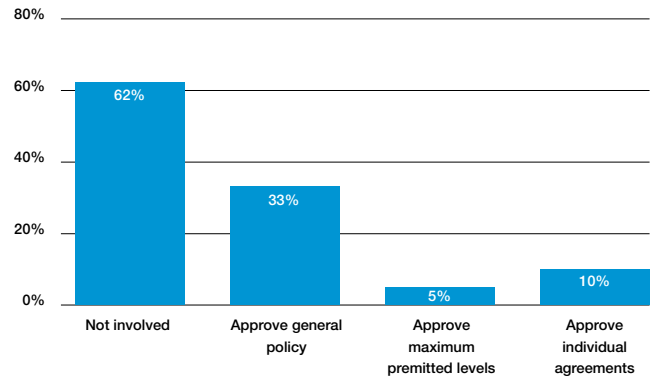
For many of the key features of distribution, a substantial portion of the Board have no involvement at all. In particular, the lack of focus on both retrocession levels and sales materials could expose certain Boards to risk as we move into a more challenging environment. Certainly, recent case law and regulation surrounding marketing documents indicate increased focus on this area, by both regulators and the ultimate investor.

Board implication in the distribution process

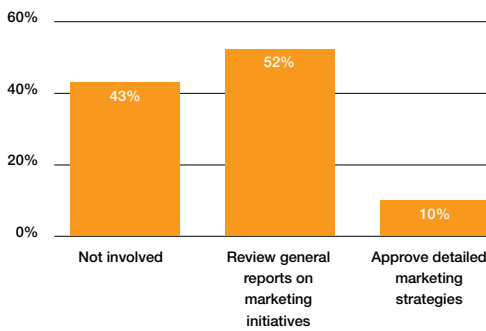
Agreements/Dealing arrangements



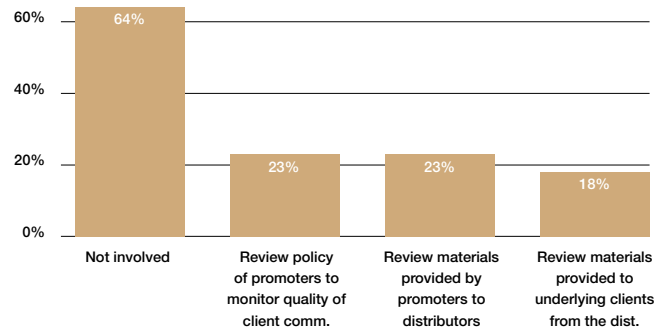
Retrocessions/Rebate level



Marketing



Distribution support/Sales materials



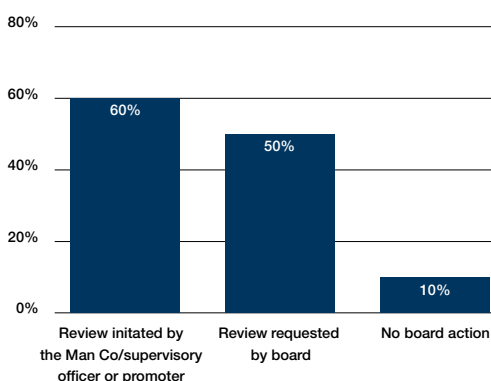
Despite the lack of oversight evidenced, Boards understand their risks in terms of distribution and place as “top three overall risks”, in order of importance, AML/KYC issues, misselling and fund registration issues. They also feel comfortable (88% of respondents) that these risks are adequately managed, which should be somewhat reassuring...

The impact of the sub-prime crisis

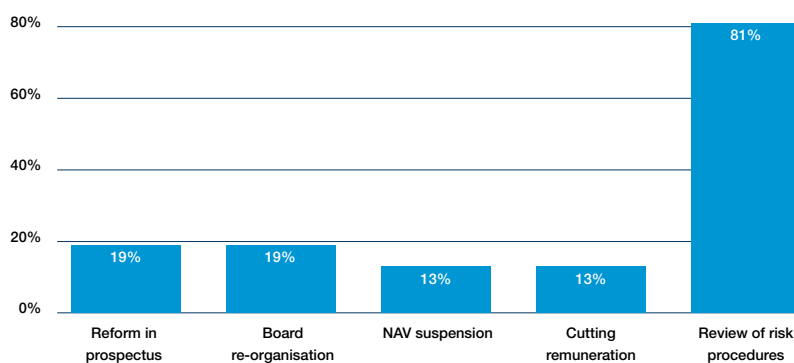
The main consequence on the funds of that crisis, for most respondents, was a flight to quality by investors by either redeeming or switching into more secure cash funds. However, it is fair to say that Luxembourg has not been hit that hard by the sub-prime crisis, at least in the last days of 2007 and the early days of 2008. For 50% of our respondents, the crisis had a limited impact, at least at the time of their response. For 45%, the impact was more significant.

Actions taken

Process for Board of crisis



Main measures taken upon crisis

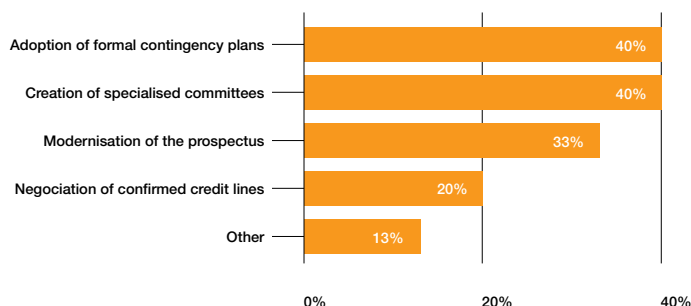


Main lessons already drawn

Importance of communication

- 60% issued a communication to clients/ only 27% to their service providers.
- 67% of them are in favour of an ongoing communication via regular reports or phone calls.
- In 50% of cases, it helps avoiding potential redemptions.

Lessons drawn



The lessons drawn out of the crisis will contribute to a better governance for those funds concerned: contingency plans were drawn for 40% of respondents, which will cover risks more holistically and, increasingly, fund Boards set up specialised committees to assist the Board when there are pricing issues - all steps which certainly go in the right direction, for establishing sound oversight and management of a fund.

Organisations have certainly learned from this crisis and more fully appreciated the key risks facing their funds. Issues such as client communication, effectiveness of controls and the fact that Board members stood clearly behind their responsibilities were all positive experiences of the crisis. Boards themselves have often had to become significantly more involved in the details of valuation, liquidity, counterparty exposure etc... Certainly, this crisis will result in a stronger, more effective and risks - aware governance framework.

Main focus of the Board in the coming months

When the world still seemed safe and bright, before Lehman and before Madoff, some of the main topics on the fund Boards' agenda were UCITS IV, risk management and the pricing of derivatives, fee pressure and market consolidation. That was when we got the responses to the survey...

Today, responses would certainly be different, as fund Boards have had to grapple with the crystallisation of previously theoretical risks. Boards will have at heart to regain the confidence of thousands of investors, especially the "little" ones, lost in the crisis, in the wrongdoings of some and the complacency of others.

Corporate governance at fund level comprising a substantive oversight of the fund's functioning by an independent-minded, competent and involved set of people, truly acting in the best interest of investors and not of their respective organisation, will be key to regaining the confidence of investors in our industry.

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ILA

ILA was formed in 2005 and has a general mandate to foster the good practices, the development and the promotion of the profession of directors of Luxembourg companies. The Fund Committee was formed at the start of 2008 and is focussed on supporting and representing the needs of the directors of funds or their management companies.

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