



Fund Follies

Mutual fund boards are being remade by regulatory fiat, but few believe the changes will benefit investors.

By Cayle B. Ronan

THERE ARE BAD DOCTORS, bad lawyers, even bad mutual fund employees," says James Bodurtha, the independent chairman of Merrill Lynch Funds who is also chairman of the Independent Directors Council (IDC), an affiliate of the Investment Company Institute (ICI), the mutual fund lobbying group. For Bodurtha and every director who takes fiduciary responsibility seriously, the recent spate of mutual fund industry scandals involving late trading, inappropriate market timing activities and misuse of nonpublic information about fund portfolios was as inconceivable as it was embarrassing. But the misdeeds were not widespread. "It's a mistake," Bodurtha says, "to generalize and tar a whole industry based on the actions of a few."

Yet the Securities and Exchange Commission did just that, in the eyes of many fund directors, when it amended the Investment Company Act of 1940 to require that 75 percent of any given fund board, including the chairman, be independent. (The prior mandate was 40 percent.) The ruling is scheduled to go into effect January 16, despite the lack of evidence that greater independent control of any board would have prevented the scandals. The SEC itself has acknowledged, in a 78-page report released on May 3, that there is no conclusive evidence that investors in funds with independent chairmen benefit from stronger fund performance or lower fund fees.

In fact, the poster child for the industry scandals, Putnam Investments, was also the poster child for "good" governance. It had a supermajority—75 percent—of independents, independent staff and independent counsel.

The lack of proof or support for how the amendments will improve governance prompted SEC commissioners Cynthia Glassman and Paul Atkins to take the unusual action of dissenting, accusing the other three of engaging in "regulatory fiat." This is also why the U.S. Chamber of Commerce filed a lawsuit on behalf of several of its mutual fund members—unnamed of course—claiming the SEC's

uncharacteristic speed and lack of due diligence was unlawful. There is a possibility that when the court rules, it will reverse the SECS amendments involving independence and send it back to do its homework. The SEC declined to comment on the issue, citing the pending litigation.

ONLY SKIN DEEP

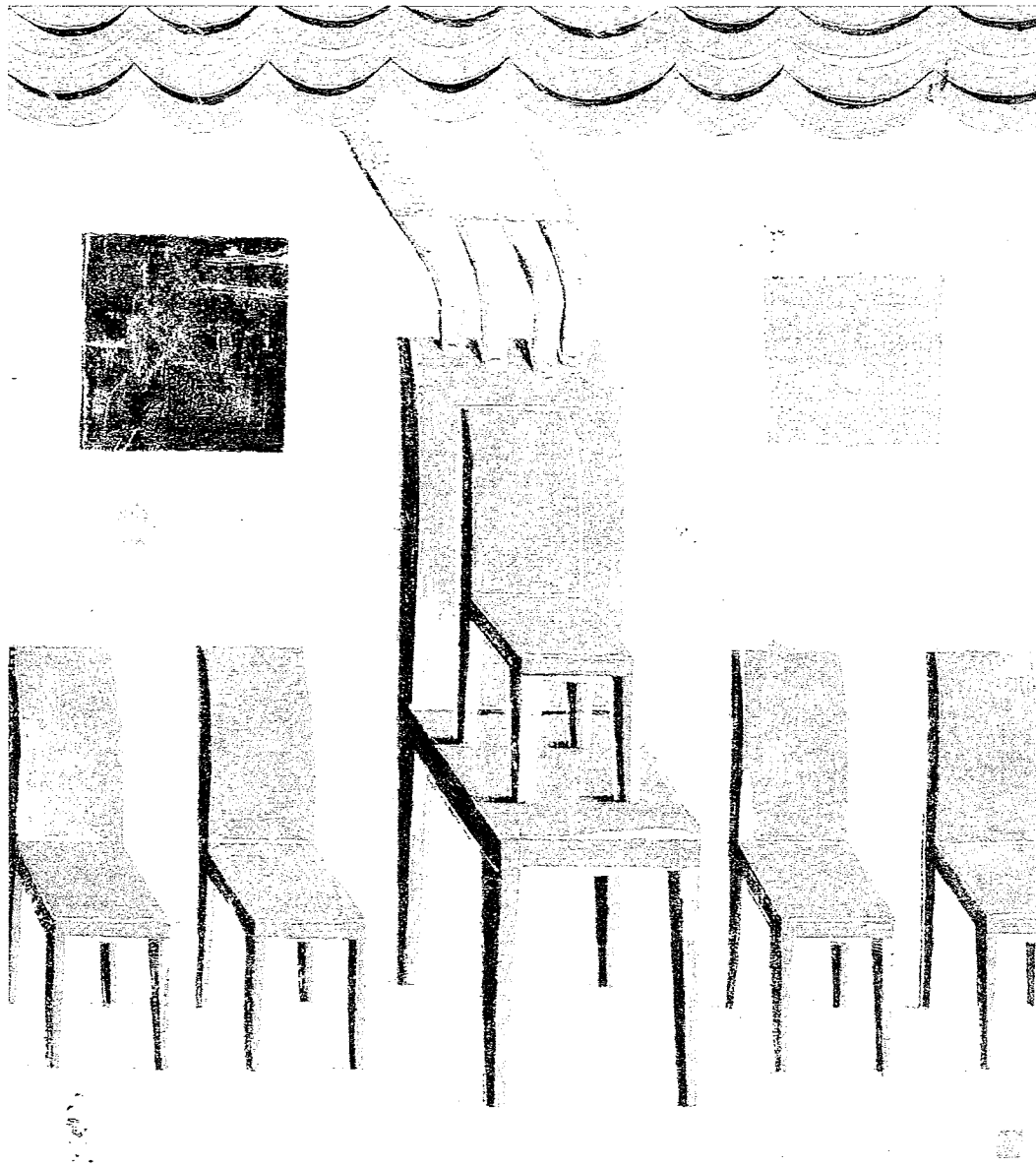
If the SEC really wants to improve the lot of shareholders, evidence is increasingly pointing to another tactic: requiring that directors have skin in the game. A study released in April called "Does Skin in the Game Matter? Director Incentives and Governance in the Mutual Fund Industry," by professors Martijn Cremers (Yale School of Management), Joost Driessen (University of Amsterdam), David Weinbaum (Cornell University) and Pascal Maenhout (INSEAD) found that significant fund ownership by independent directors correlates strongly with well-run funds and higher returns for shareholders.

The study found, however, that ownership by independent directors mattered only if nonindependent directors also had large investments. "Contrary to recent moves to expel nonindependent directors from the boardroom," Cremers says, "it is exactly those funds in which the nonindependent directors' incentives were aligned with those of the shareholders that we find the strongest fund performance."

Further, the study found no correlation between fund performance and the number of independent directors on the board. "Independence does matter, but it is not the whole story," Cremers explains. What is optimal is to attract those directors who believe in the funds—with share holdings and low cash compensation. "The bottom line," he adds, "is that if the SEC wants directors to think like shareholders, then maybe the best way to do that is to make them shareholders."

In fact, the ICI's Best Practice Guidelines, which many larger fund families began using as a benchmark when it was released in 1999, already stipulates that fund directors should invest in the funds on whose boards they serve. These guidelines are as, or even more, stringent than those the SEC seeks to enforce. In fact, ICI Guideline No. 1 on a

TOP VIEW The SEC has been hard-pressed to justify a new rule requiring mutual fund boards to boost their number of independent directors, issued in response to the scandals of the recent past. But those serving on mutual fund boards may find this dictat is the least of their regulatory problems.



list of 17 reads: "Independent directors should account for two-thirds of the board membership."

Owing to the adoption of the guidelines by ICI members, many boards are already just one director shy of conforming to the SEC's dream figure of a 75 percent supermajority. This explains why the frenzied recruiting rush that consultants were expecting to capitalize on has not materialized. Rumors of nervous board members and boardroom shake ups have turned out to be mostly a function of ad copy created by vendors hoping to sell directors services to help them cope with change. In fact, the only perceptible shaking going on in boardrooms these days is of heads—mostly prompted by the sentiment that the action represents too little too late.

Akin to the SEC's ruling, the ICI enacted its guidelines without proof that increasing the number of independent board members would increase the quality of governance.

But that was never the point behind the recommendations. According to IDC managing director Marguerite Bateman, the two-thirds figure reflected the average board construction at those funds deemed well-governed. Bateman also recalls that part of the reasoning behind recommending a two-thirds majority involved the potential problems caused by sudden departures. At the SEC's previously mandated 40 percent—and later 50 percent—level, if an independent director died or needed to step down immediately, management directors might have a temporary advantage in any board rulings. At two-thirds, this was not likely to happen. The advantage of the SEC's three-quarters requirement over the ICI's two-thirds, however, eludes her.

Bateman also worked on drafting the ICI guidelines, which entailed "conversations involving hundreds of people from all areas of the industry." She remembers hearing strong arguments for having a number of management

company directors on boards. "The feeling is that management should have the same fiduciary responsibility as the independent directors. Moving to minimize or eliminate them from the board lets them off the hook, relieving them of sharing the same fiduciary obligation."

DISSENTING PIONEER

John Bogle is one—apparently lone—proponent of further government-mandated reform in the industry. Bogle, the legendary founder of Vanguard and pioneer of index mutual funds, now presides over Bogle Financial Markets Research. He is campaigning for a statutory, albeit mostly symbolic, standard a federal standard of fiduciary duty. On a more practical level, he would like to see more stringent requirements supporting skin in the game. "Directors should have their own money in the fund, and they should act as if every penny they own is in that fund," Bogle argues. "Better yet, they should act as if they are the sole shareholder in that fund."

As for how many funds practice this guideline, industry statistics are not available yet because funds have only recently been required to gather any data on director ownership. Dawn-Marie Driscoll, the independent chair of Scudder Funds, says the firm strongly encourages independent ownership across all of the funds each director oversees. "This is why I have to explain to my accountant every year that as a Florida resident, I own a Massachusetts municipal bond fund," she notes.

It does appear that the SEC has begun to shift its focus from board structure to another area that has been an ongoing concern for Bogle and others: that of fees and expenses. It is examining which benchmarks are being used to determine the price of services. Regulation would mean boards would have to spend more time benchmarking compensation, focusing on contract renewal guidelines and costs, and continually assessing service and vendor expenses to keep fund expenses down.

But the shift toward lowering fund costs is not waiting for SEC guidance. Judging by the preponderance of fund family advertising, it is already receiving priority in boardrooms.

Several other issues may come up for industry or even government scrutiny in the near future. First is the question of how many funds a single board can reasonably be expected to oversee. The ICI guidelines recommend either a single board for all funds or cluster boards for groups of funds within the complex, rather than a single board for each individual fund.

THE LIMITS OF OVERSIGHT

To answer investor concerns that one board cannot adequately oversee management of upward of 100 funds, the SEC is requiring that boards conduct an annual assessment of their capabilities. For many directors, that is a preferable alternative to setting limits.

"The number of funds one oversees does matter," Driscoll says. But she believes it matters because the more funds a board oversees, the more professional the board must be to do its job well. "If you have 140 funds in a complex, you want one board, not 10 boards overseeing 14 each. Not only is that a waste of shareholders' money, it dilutes board power over the advisor. You also run the risk of the individual boards creating policies that are at odds with each other. Basically, it's like saying Procter & Gamble should have a board for each product."

Another area the SEC may address in the future is elections. Some investor advocates are calling for annual elections, which most directors see as unduly expensive. Driscoll, who believes elections should be held no more often than every five to 10 years, says, "It's not like a publicly traded company where you have big institutional investors that keep the numbers down. Mutual funds have millions of individuals who have to be solicited. Where independent directors are responsible for the selection of the

other independents, there is already a lot of shareholder protection built into the system."

The mandated change to an independent chair may prove a more troublesome compliance challenge for boards. Many directors feel it defeats the SECS goal of greater independent control by removing the ability to choose the best director to serve as chair; many prefer the ICI suggestion of installing a lead independent director to work with a management chair. The 'mandate for an independent chair will not necessarily guarantee a leader who emphasizes shareholder concerns above all others. According to Bodurtha, "Under our [independent] management chair, whenever we asked what we could do for the shareholders—which we do at every meeting—the question of cost versus benefit was never an issue." Even so, he acknowledges, Merrill Lynch's recent switch to an independent chair, which was brought on by the retirement of the management chair rather than SEC mandate, noticeably changed the tenor of the board meetings. "With an independent chair at the head of the table, there is even more of a slant toward the shareholders," he admits.

Everyone, dissenting commissioners included, seems to agree the SEC must tone down its rhetoric and watch how the changes it has set in motion over the past few years play out. As much as directors may resent the interference, most seem to realize that these changes are now part of the fiduciary duty of being responsible for billions of investor dollars. While critics of the SECS amendment continue to argue that the commission acted in haste to simply show that it was doing something—*anything*—to try to create a more level playing field for mutual fund shareholders, the rule changes actually offer little in the way of new protection. ■

Gayle B. Ronan, a former private banker and advisor, writes frequently about wealth management. ronan1@comcast.net