

## **Assessing the Costs and Alternatives of an Independent Chairman for Mutual Funds**

*(by C. Meyrick Payne, Senior Partner of Management Practice Inc., a consulting firm  
specializing in the governance of mutual funds)*

By now virtually everyone in the mutual fund world knows that the US Court of Appeals recently remanded the SEC's decision to require 75% independent membership on a fund's board and an independent chair of mutual fund boards back to the Commission so that it could specifically address two issues: (1) the cost of implementation and (2) use of disclosure as an alternative. Since the Chairman and one other Commissioner, who are very familiar with the issue, were about to step down, the SEC decided to hold the required hearing one day before the Chairman's resignation became effective. This MPI Bulletin provided some facts to ease the debate. The independent chairman and the 75% Board composition rule was re-adopted.

### Costs

The costs of implementing these rules are minimal. The 75% independence requirement represents no change from the existing "safe harbor" rule which already requires 75% independence for two years after any merger or acquisition by the investment manager. In MPI's latest survey of the fund industry, fund boards were shown to be getting smaller as insiders stepped aside to achieve the 75% requirement.

As to the independent Chair rule, there are about 300 mutual fund families in the US. On average the Chair of each will receive incremental compensation of about \$25,000 for a total cost of \$7.5 million, which is tiny compared to the \$8.3 trillion of mutual fund assets. Furthermore the impact of these incremental costs is proportional to the size of the complex; for example 30 fund families account for about 75% of all fund assets, the Chair of each of these is expected to receive additional compensation of about \$75,000, or just \$2.25 million, to oversee all \$6.2 trillion. The 270 smaller complexes will pay an average Chairman's premium of about \$20,000 or \$5.25 million.

An independent Chair is needed to strengthen an already cost effective process of fund governance. Consider that there are only 2,800 independent fund trustees in the country (there are over 700,000 lawyers and 600,000 doctors). Of these, 306 are trustees of the 30 largest complexes. From an individual fund investor's viewpoint, each \$1 million of fund assets in these large fund families (about the value of a comfortable home in suburban New York) costs \$1.93 per year for an independent trustee to personally stand guard. Compare that to a typical home security system!

From a taxpayers' viewpoint, fund governance is also remarkably inexpensive. Compare 2,800 trustees (plus about 400 SEC staff) with the approximately 30,000 bank regulators at the Federal and State levels. The US system of fund governance is generally envied throughout the developed world as effective and cost efficient.

The benefit of an independent Chair is that it clearly separates the investors' interest from that of the manager. Whenever one individual's hard earned money is entrusted to another, potential conflicts of interest arise as they did in the recent late trading, market timing and portfolio disclosure scandals. These conflicts are only magnified when millions of individuals' savings are aggregated together in extremely large investment pools.

The conflicts include the allocation of IPO rights, potentially higher-than-necessary fees and expenses, excess brokerage, sometimes enormous bonus pools, "soft dollar" research credits and unnecessary portfolio churn. The average fund investor can not possibly know enough about these esoteric conflicts to look out for themselves and, as those who oppose this rule argue, vote with their feet. The fund directors are needed to represent the average shareholder – and they need an independent Chairman to guide them, prioritize issues and manage governance resources in an increasingly complicated environment. They also periodically need someone to go toe to toe with the CEO of the management company.

An independent Chairman is also needed to ensure that two other SEC important reforms are truly implemented. First, the requirement that the fund board annually evaluate its own effectiveness becomes toothless unless there is an independent Chair who is empowered to act on the results. Second, the newly appointed Chief Compliance Officer needs a boss of the same stature as the management company CEO. Without one, the role of the CCO is potentially just window-dressing.

Furthermore, the act of rescinding the independent Chairman rule would be worse than never having had it at all. To signal the fund marketplace that a majority of SEC Commissioners (and the SEC staff) thought that the rule was an appropriate response to the late trading, market timing and portfolio disclosure scandals; but then, under new leadership, change its mind, sends an alarming signal at a time when politicians of every stripe are advocating greater personal savings.

### Disclosure as an Alternative

Two SEC Commissioners and the US Chamber of Commerce have proposed that disclosure of whether a fund has an independent Chairman would suffice. The trouble with this argument is that SEC knows full well from its recent focus groups that fund prospectuses and annual reports are rarely read. Furthermore the benefits of an independent Chair to actually mediate conflicts of interest are not obtained by disclosure.

About 30 complexes have already appointed an independent Chair (in addition to the 33 or so which already had them) in anticipation of the rule becoming effective. Morningstar reports that 11 of the top 20 complexes already have an independent Chair. In our firm's work with many of these, I know of none which would return to the old days of an inside Chairman, even if the SEC were to reverse its position.

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In summary, the cost of this rule is minimal, the need is conspicuous after the scandals of the past two years, and the alternative proposed is not an appropriate way to achieve any of the benefits.

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