MANAGEMENT PRACTICE®

More Work, Fewer Assets; Impact on Director and CCO Compensation

By Jay Keeshan and C. Meyrick Payne, Management Practice Inc. (MPI)

The last quarter of 2008 saw unprecedented upheaval in the financial markets. New revelations of crises and scandals broke almost weekly; the most recent being the colossal Madoff investor fraud, which involved an investment offering that turned out to be a Ponzi scheme. Standing relatively untarnished amidst all of this has been the mutual fund industry. Apart from a few isolated incidents, the overwhelming majority of the industry has performed as intended, providing diversification, transparency, and liquidity to shareholders. While performance and flows are down, and downsizing -- along with the rest of the industry and economy -- will likely take place, it is clear that the mutual fund industry will survive this crisis and, in our view, successfully emerge as a solid model of safe, effective, and well-governed money management.

In this environment, independent mutual fund directors and the regulations that empower them have played a significant role in the industry's success. Most directors have faced a substantially increased workload in the form of additional meetings and materials to review. Many have been presented with new issues to understand and manage, including ARPS, CMOs, and CDSs, and the once relatively routine review of money market funds has topped many boards' agendas. Some directors may also feel increased legal exposure.

Presented with the task of setting their own compensation, directors must resolve the dilemma of ensuring that they are fairly paid. In addition, they are responsible for setting the pay of their Chief Compliance Officer, who faces similar new challenges.

Director Compensation

Over the past 5-6 years (since the scandals at the start of the decade) many boards have been increasing pay to get to fair levels in the age of heightened workload, stricter compliance regulations, etc. For many years the annual increases were in the double-digit percentage range. Recently the growth rate had begun to drop off, and single-digit growth rates were more typical as compensation began to "catch up" for most boards.

By all accounts this trend was expected to continue even before the financial meltdown. Now recent conditions have warranted a complete re-evaluation of the yearly pay setting decision. In conversations with directors over the past few months, some boards seem to be planning to make no changes to their current compensation. A few may proceed with planned adjustments which were overdue based on recent structural changes (more or less funds due to mergers, etc). But the general expectation as they head into their first meetings of the year is to stay put for the moment. The market weakness and bulk of the crisis of confidence are barely four months old, so any change either up or down may be unwise or unwarranted.

While fund director pay may be steady or frozen in the near term, the question of how to ensure fund boards are fairly paid will remain important. Directors will need to continually assess their compensation level and form even if they do not plan to make changes. Industry studies of director compensation provide one good method of doing this. The metric commonly used by many to assess compensation—assets under management—has never been the best driver. The tables provided in these reports are meant to be descriptive; there is indeed an overall correlation of assets to director pay. However they are not meant to be prescriptive. Every board is different and should be analyzed as such. There are numerous unique variables that might be considered. As an example, the number of funds overseen continues to be a relevant number. This metric may come more into play as some fund companies step up their plans to rationalize their fund lineup.

In most cases the director job is more intense in the current turbulent environment. As a result, it is even more important that trustees ensure they are paid properly through a full assessment of their particular workload and risk involved, as well as what their expertise would earn in similar roles elsewhere.

CCO Compensation

CCO compensation is another area that will require attention from fund boards. As is the case for directors, many CCOs have also been faced with an increased workload, new issues, and stressed compliance budgets. Directors have the authority of approving CCO compensation, so they must weigh the fact that the industry is in a downturn against the fact that they need the expertise of their CCO more than ever.

The feeling by many is that CCOs will likely feel some downward pressure on their compensation along with the rest of the industry. In many cases, increases on base pay may be frozen or attenuated. Where the downward pressure is more likely to be felt is in the bonus, which can represent as much as 200% or more of base pay for some CCOs at larger complexes.

Bonuses will likely be more affected for those that have equity incentive programs in place (stock options, etc.); in effect, those who stand to gain from more prosperous times. Those with less potential for gain in good times will likely feel less downward pressure during the crisis. The SEC has made it clear that the overall compliance effort should not be reduced. As directors give final approval on CCO compensation, some suggested they might offset pay decreases from the management company, at least partially, with participation from the funds.

***

Independent mutual fund directors and their CCOs are critical to the good governance and continued success of the fund industry. As the new administration and SEC Chair take control, it is likely that the US mutual fund governance model will be considered for other areas of the financial landscape; notably hedge funds. The need to attract and maintain qualified people to participate in this process with fair compensation will surely continue.

Contact: Jay Keeshan
Management Practice, Inc.
216 West Hill Road, Suite 200
Stamford, CT 06902

Email: JKeeshan@MFGovern.com
Phone: (203) 973-0535
www.MFGovern.com