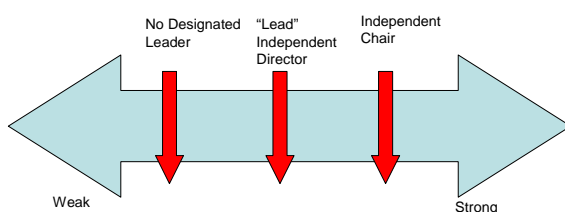


Debating the 75% Independent and the Independent Chair Rule

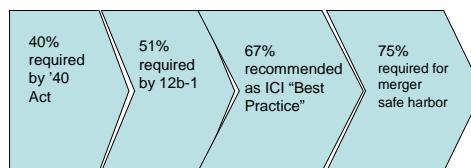
By C. Meyrick Payne, Senior Partner, Management Practice Inc. (MPI)

Make no mistake, the current debate in the mutual fund industry is about how powerful Mutual Fund Directors need to be to protect America's savers from potential misdeeds of those who control the \$8.5 trillion dollars of mutual fund money. Generally speaking fund directors have been becoming more powerful for many years, particularly since a leader of the governance process has been identified. This MPI Bulletin looks at the substantive arguments on both sides.



Hardly surprisingly, well-heeled money managers want to limit their authority and consumer advocates want to enhance it. Disingenuously, the opposition has redirected the debate away from the substance of the argument to the process by which the SEC implemented these rules.

First, the relatively uncontroversial 75% rule is just another step in a long term progression of independence as mutual funds have become more important to middle income savers. MPI surveys show that the preferred way to achieve 75% independent is to have an insider step off the board.



Second, there are four major arguments advanced against the independent chair rule: (1) alternative disclosure, (2) board's prerogative to decide, (3) dollar cost and (4) economic cost. Each of these is easily rebuffed as one thinks about safeguarding the typical fund investor, who today is a relatively less-well-off saver and is using mutual funds as a home for his or her family's 401(k) plan.

1. Alternative disclosure. Some critics argue that disclosure in the SAI or prospectus that a fund does not have an independent chair should be sufficient warning for those mutual fund investors who care. From well published ICI research and SEC focus groups we know that investors do not read this type of relatively mild disclosure. More severe disclosure, such as that used in the tobacco industry, would be unnecessarily provocative and may even hurt the industry.

2. Board's prerogative to decide who is Chair. While intuitively attractive that Boards should be trusted to decide who is Chair, Canary Capital and market timing scandals show that the industry can not always be trusted to act in the shareholders' interest. On the other hand, strengthening the role of independent directors and the board heightens responsibility and accountability to fund shareholders.
3. Dollar cost. For 14 years MPI has researched and documented the cost of mutual fund boards. There are about 300 fund families; under this rule each would have an independent chairman. On average this person would receive a premium of about \$20,000 each, bringing the total dollar cost to \$6 million – inconsequential when compared to the \$8.5 trillion mutual fund industry. MPI has come to the conclusion that it is not reasonable to attribute the cost of Sarbanes-Oxley or other regulatory reforms to the independent chair rule because they will continue whether or not the rule is adopted. Indeed without the strong leadership implicit in the independent chair rule, there is a danger that these other reforms will turn out to be ineffective.
4. Economic cost. When serious fund professionals argue that the cost is too great, they probably mean economic cost. They worry that innovation, creativity and entrepreneurship in the fund industry will be impaired by an independent chair. However, a mutual fund is a fiduciary vehicle, not an operating company and no one is suggesting that the entrepreneur who starts a vibrant investment management company should not continue to serve as chair of that company. It does however necessitate that independent mutual fund chairs learn to differentiate between good governance and micro-management. The ICI, IDC and MFDF will have major roles to play in the continuing education of newly empowered fund boards. Very importantly, the advent of an independent chair for a mutual fund is in no way a precursor to the European style independent chair for operating companies.

In conclusion, the adoption of the 75% and Independent Chair rules are appropriate responses to the changes and scandals which have impacted our industry in the past four years. Mutual Funds have become preferred savings vehicle for millions of middle income savers; they are no longer just an investment alternative for institutions and well-to-do Americans, particularly those who are virtually locked into a narrow choice because they are offered on a 401(k) platform. These savers deserve and require stronger protection from unfair treatment as occurred in recent scandals. Stronger fund boards are a cost efficient and tailored way to safeguard the shareholders' interest - as long as Fund Directors stay focused on good governance and not micro-management.