MANAGEMENT PRACTICE®

Independent Boards of Directors: A Model for the Rest of the Financial System

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As Washington shifts its focus to financial reform, Congress would do well to consider a system of governance that has worked effectively in overseeing one particular (and significant) element of the economy. For nearly 70 years independent mutual fund directors have provided extremely efficient oversight over trillions of dollars for millions of US investors. Given the issues experienced during this recent financial crisis, perhaps the concept of independent oversight should be extended to other areas that require similar protection. In particular, mortgage and consumer debt lending or retirement planning could benefit from the cost efficient, unconflicted and truly informed governance that US mutual funds enjoy.

The mutual fund industry—from an investor protection standpoint—is emerging from the financial crisis relatively unscathed. With just a few exceptions funds have functioned as intended. Any issues that did arise have elicited changes that have served to further strengthen the system. The mutual fund industry as a whole should be viewed as having weathered the storm relatively well, and the governance provided by fund boards played a key role.

Why did only mutual fund investors benefit from this type of financial protection? While the structure would likely differ, the general concept of board-level oversight could theoretically work (in varied forms) to oversee other areas, including mortgage and consumer debt lending, retirement savings, financial planning, alternative investments, insurance, ratings agencies, and others.

Most fund management companies do their best to act as fiduciaries, and in many ways, their interests are aligned with shareholders; good investment performance is good for everyone. However there will always remain some level of conflict, requiring a system of checks and balances that is so integral to our governing system. Some believe that the mere presence of boards alone is effective in protecting shareholders. Many other financial areas have the potential for even greater conflict, and independent directors could provide effective protection.

The role and impact of independent boards has evolved significantly over the years. The perception that fund directors simply show up at a few meetings a year to "rubber stamp" the management contract and then head out to play golf is misguided. The vast majority of fund directors are highly accomplished professionals who take the job very seriously. The workload is enormous, as is the potential legal exposure if they do not perform their duties properly. Additionally, virtually all independent directors are truly independent, with no ties whatsoever to management. And few (if any) are motivated by the fees they are paid. Rather, most are motivated by a sense of duty, based on their knowledge, experience, and impartiality.

A significant factor to consider is the cost efficiency of this independent governance. Fund directors provide great assistance to the SEC in numerous ways, allowing them to have eyes and ears at a granular level. Yet the cost of this oversight is not borne not by taxpayers, but rather is proportionately charged to those investors who directly benefit from the protection.

The cost of board governance to the investor is extremely low. Roughly 2200 independent directors in the US oversee approximately $12 trillion in assets. The total cost of this governance is estimated at about $300 million dollars. This compares with management fees that (when computed at a 1% management fee) would total $120 billion. Taken from the shareholder's perspective the cost is infinitesimal; at larger funds the board costs (on average) just under $18 annually per $1 million invested. Compare that $18 to the cost of electronic monitoring of a $1 million home, which typically runs $400 a year or more. And this compares to as much as $10,000 or more in other fund management expenses for the same $1 million.

Another favorable condition is that the US has a solid pool of candidates to draw from. There is no shortage of highly qualified individuals of all ages and backgrounds willing to take part. The US demographic profile suggests we will see a steady supply of experienced boomers who would likely be happy to serve for many years as they retire. Why not take advantage of this resource?

It is worth noting that a few years ago—before the crisis—there was a movement to remove or downplay the role and authority of mutual fund directors. One rationale given for this was to allow the US to become more competitive in global financial markets. Yet mutual fund fees in the US are lower on average than virtually anywhere else in the world. Fees just over the border in Canada, where directors' authority is limited, are as much as twice as high. The independent governance model could indeed become one of America's most valuable exports.

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The concept of using truly informed and educated individuals to assist in overseeing the US economy and protecting Americans' finances should not be overlooked. The highly effective governance provided by independent mutual fund directors provides a structure around which oversight for many financial areas could be built.

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