

## Building a Process to Recruit a Diverse Fund Board

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The concept of diversity evokes thoughts of race, ethnicity and gender to most, but these are by no means the only forms of diversity that the SEC has in mind with its new disclosure ruling. The SEC has wisely not defined diversity, on the grounds that each fund board knows best what they need, whether this includes education, profession, risk orientation, income, motivation for investing, family size, or other factors.

The SEC recently expanded corporate governance disclosure to require a board to report if the nominating committee has a diversity policy, and if so, how diversity is defined, how the policy is implemented, and if it is effective. The purpose of this MPI Bulletin is to outline a process for achieving a “diverse” board and to provide some ideas towards addressing the required disclosure.

### Strengthening the Process of Board Self-Evaluation

The first step in the process to ensure diversity is to strengthen the existing annual board self-examination and assessment. Much has been written about self evaluation. Clearly the most important aspect is to ensure that all independent directors are clear of conflicts. The next is to honestly evaluate how well the board works as a whole, meaning how it reflects the needs of the fund shareholders and the rules that regulate fund operations.

### Setting the Criteria for New Directors

Setting the criteria for new fund directors is the next step in the process. Typically there are two parts to the process of setting criteria: (1) trying to reflect the fund family’s shareholder base and (2) filling gaps in your current board’s expertise in relation to the board’s likely future needs.

1. Reflecting the shareholder base. The most obvious place to look for demographic and psychographic information about a fund family’s shareholder base is the marketing and sales departments. New investors will often have a different profile than the established fund shareholders. Such an analysis will often show that new fund purchases are more frequently driven by female decision makers and that job-related considerations are an ever-increasing component of a successful sales program. This implies that women, who often make up more than 50% of the fund holding and acquiring decisions, should be proportionally represented. In fact France and Norway have now mandated that 40% of corporate directors be female. An Ariel Funds study<sup>1</sup> also shows that minorities make up a smaller but growing proportion of mutual fund shareholders.

In spite of these trends, the 2010 MPI Survey of Mutual Fund Trustee Compensation and Governance Practices finds that only about 15% of the in-place fund directors are female and about 20% of the new appointments in 2009 were women. No current analysis we know of has identified the proportion of ethnic minority fund directors.

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<sup>1</sup> 401(k) Plans in Living Color. Ariel Funds LLC/Hewitt Associates LLC 2008

2. Filling Gaps in Board's Expertise. Each fund board should project what it believes the future challenges might be and ascertain if it has the right talent in place on the board to meet those challenges. For example, in the past few years many fund boards have found that they are insufficiently staffed in investment expertise; several years ago fund boards were often short of compliance or accounting expertise; and in an era where marketing plays an ever-increasing role in the determination of a fund economics, marketing experts can be in short supply.

The cohesiveness of the board is a crucial consideration. An over-zealous or single-issue director is not helpful to constructive action. On the other hand using cohesiveness as an excuse for lack of diversity defeats the very purpose of having multiple points of view on the board.

### Creating Vacancies

An important part of the diversity disclosure is to outline how periodic vacancies on the fund board are addressed. There are only about 2200 fund directors in total and on average 200 vacancies per year. The majority of these vacancies are created from retiring directors.

However in recent years there has been a tendency to revise the retirement age policy, so that shareholders can continue to benefit from long serving members and their extensive knowledge and familiarity with the funds. In MPI's 2010 Compensation Survey over 70% of fund boards have a mandatory retirement age and 72 is the most frequently reported. For boards to continue to experience regular member cycles, an enforced mandatory retirement age is almost a necessity for a successful diversity process.

### Reaching Out to the Potential New Director

The new disclosure rules inevitably mean that many fund boards will use executive recruiters to ensure that they have the broadest possible selection of candidates. This will probably be the safest way to guard against charges of cronyism.

While considering additional educations, professions, ages, genders, or what the board might include in its definition of diversity, it is also important to the shareholders to remember the complexities of governing mutual funds and the necessity of a substantial knowledge of investments, compliance, accounting, and the law. And above all, fund boards need to ensure that they have the requisite mix of skills to effectively govern under the applicable rules and regulations.

### Continuing Education for Fund Directors

New board members will face challenges becoming acquainted with the idiosyncrasies of the fund business. There will be a great need for new director orientation and continuing professional education, which should be included in the nominating committee disclosures.

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Management Practice Inc. is a specialized consulting firm based in Stamford, Connecticut, and provides governance, economic, and business advice to mutual fund boards.