Selected Mutual Fund Governance Bulletins

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The "Value Added" Contract Renewal Process

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

Recent industry events have prompted MPI to re-release this bulletin, which was originally published in 2008.

Since the inception of the Investment Act of 1940, one of the critical duties of mutual fund directors has been the annual approval or renewal of the investment advisory contract. As part of the process, directors must review crucial data for each fund they govern, which includes comparisons with peers on numerous issues including investment performance, fees, and profitability. In addition to the profitability of the advisory contract, directors must review and evaluate any potential "fall-out benefits" to the advisor that may result from other fees charged to the fund (i.e. transfer agency or administrative fees). An SEC ruling in 2004 requires that directors disclose information on how and why they came to various decisions they make during contract renewal.

The volume of financial data can be dizzying to even the most veteran directors. Faced each year with the daunting task of reviewing and analyzing the board book and numerous other accompanying documents, many directors are now turning to outside assistance for "value-added" expertise as they make their way through the contract renewal process. The contract renewal books typically provided are just too big and heavy for the directors' deliberations. The perspective and "value-added" expertise offered by an outside consultant offers numerous benefits to both directors and shareholders.

The typical process in "value-added" contract renewal can vary based on the particular characteristics of the complex and the source of the data, but in general it involves the following topics discussed below.

Data Gathering and Analysis

Under the supervision of the "value-added" consultant, the process of creating the data gets underway immediately. Peer groups, usually 8 to 16 similar funds selected based on assets under management, investment objective, and distribution approach, are pulled for each fund. The data is sourced in one of three ways: 1) by the management company under the consultant's supervision; 2) by an outside provider under the consultant's guidance or 3) directly by the consultant using one of the commercially available mutual fund database providers.

The comparisons are run and each fund's percentile rank is determined for each metric. Working with the board the "value-added" consultant determines the decision criteria for the data; that is, at what level a certain metric passes a threshold and becomes an exception or outlier.

Drafting the "Value-Added" Memorandum

At this point the consultant drafts a memorandum that summarizes the data and, more importantly, identifies the outliers based on the decision criteria mentioned earlier. The memo is broken up into several sections covering key issues for contract renewal, typically:

- Investment Performance: For contract renewal we have typically found that reviewing 3 or 5 year performance is appropriate because it is long enough to capture most parts of the business cycle, yet not so short that it reflects short term swings in the market. We also believe the directors should see a fee comparison with other investment products offered by the advisor and with the low-cost provider in the industry, typically Vanguard or Fidelity Spartan.
- Portfolio Operations: We have found that fund directors benefit from understanding performance in the context of (a) style drift, (b) tax effectiveness, (c) best execution and brokerage and (d) implicit risk in the manner the portfolio is managed. The "value-added" consultant can summarize this information for the board.
- Expenses and Fees: MPI has found that total expenses form the most important metric because they represent the aggregate erosion of performance. The largest line items expenses are usually management fees, transfer agency, distribution (including shareholder servicing), administration, fund accounting and custody. Expenses which are paid to affiliates of the advisor receive particular attention from the "value-added" consultant.
- Breakpoints in the Advisory Fee: We have found that the directors benefit from seeing a comparison of the structure of the management fee (which may include both advisory and administrative fees). Some funds have a high starting fee followed by a rapid scale down, while others maintain a lower fee throughout the structure. Typically we like to compare effective management fees at a common asset level for all the funds in the peer group.
- Sales Charges: We have come to believe that the directors are well served by a comparison of sales charges from funds which compete directly.
- Shareholder Service Levels: While the "value–added" consultant does not typically create any new service level metrics, we believe it is useful to have a summary of results incorporated in the contract renewal memorandum.
- Profitability: MPI has found that the best metric for assessing fund-by-fund profitability is before marketing and before taxes. Historically fund directors have asked for more detail when the profitability exceeds 77% (the maximum rate set in the Gartenberg decision). However under the new Harris decision MPI believes that fund directors may have even more discretion.
- Waivers and Expense Caps: A "value-added" consultant is able to help the directors assess and compare the net, after waiver, expenses.

A number of evolving drafts of the "value-added" contract renewal memorandum are submitted to the board over a period of several months to ensure accuracy and confirm that all issues are being covered as intended. Once finalized it is officially entered into the record on the date of the contract renewal meeting. A benefit of the evolving nature of the draft is to allow directors to ask for and receive additional information from the management company.

The "value-added" process can save countless hours for the directors, allowing them to focus on what is truly important. The memorandum can effectively summarize 500 or more pages of material into a 10-20 page document.

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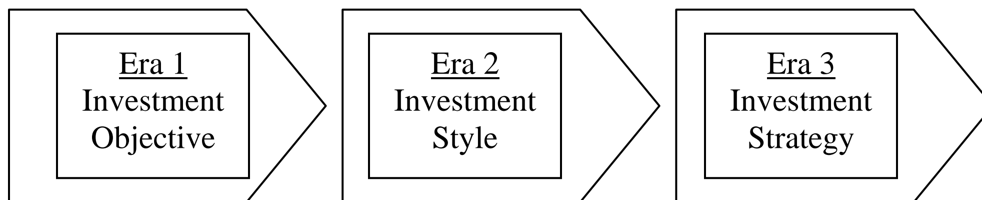
Three Eras of Selecting Peers for Contract Renewal: Using Investment Strategy Rather than Objective or Style

By Sara Yerkey and Meyrick Payne of Management Practice Inc. (MPI)

For many years the principle methodology for selecting peers to assess investment performance as well as fees and expenses has been based on either investment objective or investment style. This MPI Bulletin argues that a supplemental selection process should include investment strategy. The principle logic behind this concept is that to a greater and greater extent the differentiator between alternate funds is based on how investment selection decisions are made rather than the result of those decisions.

We note that there have been three eras of peer selection: (1) investment objective – the original designations which were for many years the preferred basis of fund stratification, (2) investment style – the widely followed stratification process which became the most effective way of describing the capitalization and strategic positioning of investment positions, and now (3) investment strategy – representing process by which positions are acquired.

Progression of Contract Renewal Peer Selection Process



There are many reasons why any of the three techniques might be appropriate in a particular contract renewal negotiation, but thus far using investment strategy has not generally been considered.

Two of the most important objectives of the contract renewal process are to (1) evaluate the nature and quality of service provided by the investment advisor – usually measured by comparative investment performance and (2) to assess the overall effectiveness of expense control, including the fairness of the advisory fees and other expenses paid to the advisor.

Typically the peer group used to evaluate investment performance is larger and more inclusive than the peer group of the assessment of expense control. This is because the investor, faced with a particular objective, has a broad set of alternative funds in which to invest. As a result the selection of a peer group to evaluate investment performance can include all the funds in particular objective, style or strategy. Indeed many fund boards use a broad based index to evaluate relative return.

On the other hand, the typical peer selection process used by boards to assess expense control produces a narrower selection of peers. This is because the focus of expense control assessment is on the drivers of cost. Many of these are related to the size of the portfolio over which to spread the fixed costs associated with managing an investment portfolio. But they are also very much related to the investment style used to select the positions included in the portfolio. Furthermore much of the law and regulation concerning mutual funds is based upon the fair sharing of the economies of scale and these often differ by strategy.

An example of some of the commonly used equity strategies which fund boards might find useful to compare investment performance and fees and expenses are shown below with a short explanation of why fund operating costs might differ.

Illustrative Investment Strategies as Fund Expense Drivers

Strategy	Likely Impact on Fund Expense Structure
Value/Underperforming	*Expensive to research often with smaller and numerous positions*
Emerging Markets	*Expensive to research and understand political risk*
Fundamental Research	*Potentially most expensive strategy depending on number of positions*
Long/short/130/30 Fund	*Among most expensive; much analysis of risk and use of derivatives*
Dividend Yield	*Quantative screens with extensive credit quality analysis*
Momentum	*Relatively inexpensive but characterized by many rapid trades*
Quantitative/chartist	*Relatively inexpensive with high systems and computer expense*
Index	*Least expensive except for licensing the index; tracking error expense*

In most cases the investment strategy of a fund is described in the prospectus. As a result it is usually possible to find an appropriate peer group for almost any equity or fixed income fund. Quite often, fund boards have agreed to a list of peers which are regularly used to assess comparative performance.

A few investment houses and independent research providers have assembled lists of funds with similar strategies. For example, AthenaInvest, Inc. (www.athenainvest.com) in Denver has developed a comprehensive strategy identification methodology for actively managed equity funds which can be used to select a peer group for either investment or expense review.

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With the ever increasing scrutiny of contract renewal decisions by the SEC and even more importantly, the plaintiff's bar, the use of investment strategy to refine the selection of peers for evaluation of investment performance and comparative expenses is an idea worth considering.

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Comparing the "Degree of Difficulty": A New Approach to Fund Director Compensation

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

In addition to the myriad duties mutual fund directors must carry out with regard to the funds they oversee, they are faced with the added burden of setting their own pay. The demands of the job, including the expertise required and time involved, justify being paid fairly. However the optics of being overpaid would not be perceived favorably by fund shareholders or the financial press.

A common approach to solving this issue is to refer to annual studies that provide compensation data based on the dollar amount of assets, or perhaps the number of funds, overseen by other boards in the fund industry. While these studies are certainly of use and can provide some comfort to boards year to year, MPI has long believed that these numbers are meant to be descriptive, not prescriptive. That is, while they may provide a snapshot of current industry pay levels, it does not automatically follow that this data should be used when setting pay.

The financial crisis of 2008 made this entirely evident. Assets under management (AUM) plummeted due to the decrease in values of the underlying securities, as well as negative net flows as investors fled to safety. This caused a few issues in the compensation data. As an example, in 2007 our survey found that directors in the $9 billion to $25 billion group earned a median of $77,942. In the 2008 report the median for this group was $117,500. This does not mean that directors in this group received a significant pay increase, but rather that the group likely became populated by a very different set of directors, many of whom were in a different/higher group in the previous year due to their larger asset size. There were additional anomalies in the data due to the dynamics of the industry, wherein the median pay levels for some asset size groups were lower than groups with lower assets levels. This would imply that directors should take a pay cut as assets grow, which of course would not be rational.

Additional problems lie in the fact that the governance duties associated with mutual funds do not generally decrease with decreases in AUM, and in fact for many over the past year the job has become ever more demanding. Furthermore there are some boards that may experience a high degree of complexity or effort, but have relatively low AUM. An example would be a fund manager that is steadily opening new and cutting-edge funds, but has relatively few assets in the early stages.

With so many boards seeking guidance for their particular situations, MPI has endeavored to try to alleviate this problem. In going beyond measuring by AUM or the number of funds governed, we have outlined a more comprehensive model that captures and measures the numerous variables that impact the "degree of difficulty" associated with fund governance.

While still in the formative stage, this new methodology examines the complexity of the job across four broad dimensions: **Structural Complexity, Product/offering Complexity, Investment Complexity, and Organizational Complexity/Breath of Exposure.** Each is discussed below.

Structural complexity examines the board's duties as pertains to the various activities of the manager. This includes the marketing platforms or distribution channels the funds are placed in, such as retail supermarkets, insurance products, retirement vehicles and workplace offerings such as 401(k) and 403(b), savings platforms like 529 plans, etc. It also considers any impact of cluster board structures, as well as the number of sub-advisors overseen. Finally it takes into account the level of new, closed, or merged fund activity initiated by the manager.

Product/offering complexity looks at the array of funds/products overseen by the board. This includes the different types of funds (equity/fixed income and money market funds, open end/closed-end, variable annuity funds, life-cycle, target date, allocation, funds of funds, international/emerging markets, specialty or alternative strategy funds, etc.) It also takes into account the total number of funds, as well as the number of share classes, and (where applicable) the variety of fee structures.

At the **investment complexity** level, an analysis of the funds' investment strategies and the makeup of the securities held in the funds is performed. This assesses the full spectrum of investments, whether they be long-only equity index funds, fixed-income, international/emerging markets securities, all the way up to the use of derivatives and alternative/hedging strategies. An attempt is also made to determine whether the fund lineup is relatively stable, or if the advisor is known for continuously producing new funds based on cutting-edge financial innovation, requiring significant continuing education for the directors. Other aspects such as tax strategies and securities lending programs are also considered.

Finally, to gauge **organizational complexity and breadth of exposure,** we look at a number of measures including analyzing the number of so called "SEC events" (e.g. mergers, liquidations, sub-advisor changes and other occurrences which require an SEC filing), as well as any public legal activity by the SEC or otherwise. AUM is a factor, as is the number of meetings and the number of sub-advisors.

Data for a "degree of difficulty" analysis can be derived from a variety of sources, including both private and proprietary databases, public filings, company websites, and even interviews with directors and industry executives. This approach helps to provide a relative framework of comparison against other fund complexes.

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As has always been the case, only the directors themselves can truly gauge the intricacies and complexities of their job, and how they should be compensated. With this new set of tools and a broader perspective, they will have better comparable data to make their compensation decisions.

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The E^3+O Process: How to Set Fund Director Compensation

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

Mutual fund boards typically evaluate their compensation annually or bi-annually, often using the traditional method of comparing their compensation to that of a peer group of directors with similar governance responsibilities; that is, similar assets under management and number of funds governed. They will often try to set their pay at the 50th percentile—or perhaps higher, say 75%—of the peer group pay range. This approach potentially facilitates a "Lake Wobegone" upward spiral effect, in which all mutual fund directors are "above average" and pay levels continue to ratchet up on their own momentum.

Whether these increases are merited or not, this "outside-in" method of setting director pay may not truly reflect a fair value for the job. A more solid and rational technique would involve evaluating the various aspects and requirements of the job to determine what rate of pay would be appropriate to attract, motivate, and retain appropriate and competent directors. This requires more of an "inside out" approach. The E^3 + O methodology described below examines the effort, expertise, exposure, as well as an additional element—opportunity cost—involved with serving as a mutual fund director.

Effort

The primary metric of effort is the number of hours spent, which can vary widely based on the size of the complex, number of funds, number of board members, and other factors. The number of board meetings held yearly is often used as a key number to work with, with a "preparation factor" of anywhere from one to three hours spent preparing for every one hour spent in meetings. Travel may also be a factor for some boards.

Once an estimate of time expended is determined, it makes sense to select a "base hourly rate" to use as a starting point. Given the background that is typically expected for a director position, it is not unreasonable to start with the same hourly rate paid to the board's independent counsel or perhaps to the fund's audit firm. The rate can vary given regional differences, but is often in the $400-$600 per hour range.

Expertise

Assessing the level of expertise helps to adjust the base hourly rate. There should be an evaluation of "degree of difficulty"; that is, how difficult the job is relative to director positions at other mutual funds. Typically governance of money market funds is rated with a lower degree of difficulty than an international bond fund. Global equity funds often require more oversight and knowledge than domestic equity funds. Some boards oversee a basic lineup of funds that rarely changes, while others must

continually approve and oversee new funds that utilize the latest innovative financial strategies, requiring the directors to continuously educate themselves to stay up to date. Each board should determine their "complex complexity" to see how they stack up against other boards.

Exposure

There are two types of exposure: legal and public perception. The first has existed ever since mutual funds were legally recognized in the 1940s. Trustees are, of course, accountable for a great many responsibilities that are prescribed by the Investment Company Act and accompanying case law. The SEC has interpreted these responsibilities broadly, and continually stresses reliance on the independent trustees as primary guardians of the investor's interests. While most suits against directors are eventually dropped or dismissed, exposure to depositions and legal preparation is substantial.

Against this backdrop arises another kind of exposure—the rough justice of public opinion. With the growing importance of mutual funds to America's retirement future, the press has paid much more attention to directors lately, with the result that their names may wind up in their local newspapers, which can potentially affect their business or personal lives.

Opportunity Cost

The final area of evaluation relates to opportunity cost. Independent trustees must remain independent, which may preclude them (and possibly their families) from serving on other boards or engaging in other business activities. Additionally there are numerous restrictions of what fund directors, and their immediate families, can invest in. As a final check on the base rate being applied to the effort expended, comparisons should be made to what the directors could (or do) earn outside their position as a fund director.

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The E^3+O method for determining trustee compensation, when used in conjunction with the more traditional approach of comparing against peer group data, presents a rational and readily defendable process. This could turn out to be crucial if the directors are ever hit with a lawsuit or, perhaps more likely, inquiries from the press or shareholders.

Management Practice Inc. is a specialized consulting firm based in Stamford, CT providing governance, economic and business advice to mutual fund boards. More information is available at www.MFGovern.com or from C. Meyrick Payne at (203) 973-0535 or email MPayne@MFGovern.com.

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Industry Dynamics Drive Fund Board Compensation Higher; 5% at Larger Fund Complexes

(By C. Meyrick Payne, Jay Keeshan and Sara Yerkey of Management Practice, Inc.)

Management Practice Inc. (MPI) has just completed its 18th annual "Survey of Mutual Fund Director/Trustee Compensation and Governance Practices", with data covering 1,971 directors from 374 fund families. Full reports and specific board compensation comparisons are available from MPI.

Year-over-year (equivalent director) compensation increased an average of 2.8% in 2010 over 2009 levels. Boards at larger fund families, however, saw an increase of nearly 5%. A few factors played a role in these increases. Many boards, still sensitive to the effects of the economic crisis, have kept pay flat; others have taken pay increases, some of which have been 10% or more. This is due to a few primary influences. Industry changes, including new products, complex investments, wider distribution models, and the regulatory environment continue to put additional strain on boards and their staff. This is particularly felt at larger complexes, where these industry dynamics are most likely to have an impact. Another influence is restructuring and M &A activity, which has eliminated some boards while increasing the responsibilities of the surviving boards (and making them more likely to take an accompanying pay increase).

Chair fees have also impacted board compensation in recent years. The vast majority of independent chairmen (as well as lead independent directors) now receive an extra fee. Additionally, the increasing focus in particular areas such as compliance, valuation, and complex investments and derivatives has continued to add to workloads for committees. Furthermore, new committees are being formed and the chairs of those committees are more likely to be paid an additional chair fee. This can have an effect on the median compensation for boards.

Pay structures have been in flux over the past few years. Recently there was a trend, particularly by larger boards, toward decreasing the impact of meeting fees, and in some cases paying a flat retainer, due to the encompassing nature of the job. Some felt that a retainer covering all of a director's duties and activities was more appropriate. The events of 2008-2009 prompted many boards to reconsider this option. The result has been renewed interest in a more flexible structure that may still include a fixed retainer, but that also has a mechanism to allow additional pay for extraordinary circumstances or events, up to an annual maximum.

Below is a sample of the pay range for a particular grouping of fund boards:

Range of Trustee Compensation for Boards Overseeing $7 billion to $15 billion in AUM (in Percentile)

	10th	25th	50th (median)	75th	90th
$7 B to $15 B	$53,170	$66,125	$84,475	$114,563	$153,925

The wide range of pay from the 10th to the 90th percentile in this illustrative grouping demonstrates that it can be difficult to properly assess pay using just one or even two metrics. For this reason MPI has continued to assess board compensation based on factors beyond AUM and the number of funds overseen.

This year MPI again assigned a "Degree of Difficulty" for boards across the industry based on metrics such as the presence of certain types of investments (i.e. foreign stock or high yield bonds), oversight of sub-advisors, and fund introduction activity. This methodology, in development over the past few years, once again provided a relatively steady progression of compensation as the level of complexity increased.

Median Director Compensation by Degree of Difficulty of Governance

Up to 120	Up to 130	Up to 140	Up to 150	Up to 160	Up to 170	Up to 180	Over 190	To 200
$15,000	$20,000	$40,000	$54,255	$77,520	$150,000	$183,128	$215,250	$186,938

Note: Not comparable year over year. Specific analysis for an individual fund family requires qualitative as well as quantitative factors.

The relative cost of fund governance remains a mere fraction of the total costs of running a fund. Total director compensation per $1 million in AUM amounted to just $17.94, nearly unnoticeable in comparison to the $10,000 in all other expenses a typical mutual fund might incur. The "Total Cost of Governance", which is the total amount paid to US fund directors as well as other board expenses such as T&E and legal expenses (as reported by NSAR filings), was $320 million, up 18% from last year but still representing only a fraction of a basis point against the total industry assets. Independent directors provide a highly efficient system of oversight that is paid not by the US taxpayer, but rather by those who directly benefit from its protection.

MPI's survey also found that 86% of all fund board members are independent and that 95% of fund boards already comply with the SEC's proposed "super-majority" rule from a few years ago. Our survey found that the chairman of the board was independent 70% of the time, up from 60% three years ago.

The survey notes that the mutual fund industry is highly concentrated, with the top 25 complexes controlling about 72% of all fund assets. These 25 complexes have about 260 directors (including cluster boards). On average, each of these large complex directors oversees approximately $33 billion worth of assets, a much wider span of influence than even directors of NYSE companies.

Our data finds that 17% of all standing fund directors are female, a slight upward tick, while 20% of the newly appointed directors in 2010 were female. Retirement policies continue to draw attention, with "director emeritus" programs gaining interest. Retirement ages have been trending upward, but the most frequently reported retirement age remains at 72.

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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. More information regarding this report is available at www.MFGovern.com or from C. Meyrick Payne or Jay Keeshan at (203) 973-0535 or email JKeeshan@MFGovern.com.

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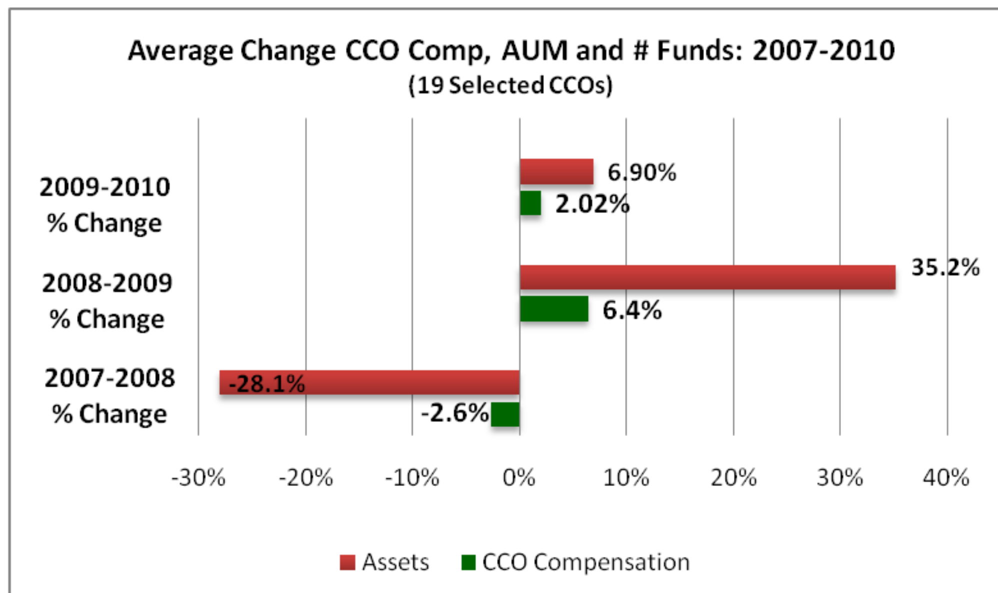
CCO Pay Holding Steady; Majority of CCOs are Lawyers

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

MPI recently completed its sixth annual Survey of Mutual Fund Chief Compliance Officer Compensation and Organizational Practices. This bulletin summarizes the findings and is based on the submissions of 63 fund CCOs, representing funds with $3.4 trillion in assets. 65% of the participants were full-time employees and serve as CCO to both the fund and the advisor.

CCO compensation overall continues to hold steady through the financial crisis, with few CCOs seeing wide variability in their annual pay. The majority of participating mutual fund CCOs again saw moderate or no increases in total compensation in 2010 when compared to 2009. The 63 participants in the 2010 study received average total compensation of $388,249. This is up from $352,034 in 2009, however the number is not fully comparable as the participants vary each year.

A subset of the survey participants, which includes 19 participant CCOs for whom data exists for 2007 to 2010, saw a modest decrease in total compensation of 2.6% in 2008, but an increase of 6.4% in 2009 and again a modest increase of 2.0% in 2010, netting to a 5.7% increase over the 3 year period. The chart below displays this change, contrasted against the varying asset levels over the same period.



The range of CCO compensation for the reporting fund families was wide and depended on many variables, such as geographic location, number of funds and portfolios, retail or institutional distribution, number of sub-advisors, and mix of insurance related products. We also found that many CCOs were long term employees of the management company, or had many years of experience at another fund company. As a result CCO compensation was sometimes correlated with age and experience.

Bonuses for CCOs typically range from 25% to 100% percent of base pay. While some of the highest-paid CCOs received as much as 200% or more before the market meltdown, that number has been decreasing and in 2010 the average bonus for large-fund CCOs was 59% of their base pay. The majority of CCOs reported that their bonus is influenced by management (87%) as well as the board (85%). 77% reported that corporate performance is a factor.

An important finding of our survey is that while most CCOs participate in the advisor's 401(k) plan, they do not always qualify for the advisor's long term capital accumulation plan. These plans are usually based on restricted share grants or qualified stock options, and are worth, in a good year, 20% to 30% of total compensation for an executive of the typical CCO's salary grade. As a result the CCO's base compensation is typically set 20% to 30% above that of his or her grade's salary range to make up for the loss of a capital accumulation plan.

As the true costs and benefits of compliance have become clearer over recent years, there has been a trend toward splitting the cost of CCO compensation between the funds and the manager. 57% of CCOs reported being paid at least in part by the fund in 2010.

We continue to see a pattern of CCOs performing certain other functions for the business. We found that 83% of the reporting CCOs perform analytical functions directly for the fund board, which might include involvement in the 15(c) contract renewal process or monitoring soft dollar expenditures. Also notable in this environment is a continued increase in "Risk Management Support" as an additional duty of the CCO, rising to 66% in 2010, up from 54% in 2007. 51% reported involvement in "Legal Support", and 45% reported having "Global Responsibilities".

Finally, the increasingly complex regulatory environment may be responsible for a change in the typical background and skill sets of fund CCOs. This year 52% of the respondents were lawyers, up from 34% in 2007. CPAs, on the other hand, represented just 20% of the participants, down from 34% in 2007.

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A CCO's compensation must be evaluated in proportion to the effort, expertise and exposure of that particular complex. CCO compensation, as with any other position, is the result of determining how best to attract, motivate and retain the requisite talent for the specific assignment. For more information regarding the MPI Survey of Mutual Fund Chief Compliance Officer Compensation and Organizational Practices, please contact Management Practice.

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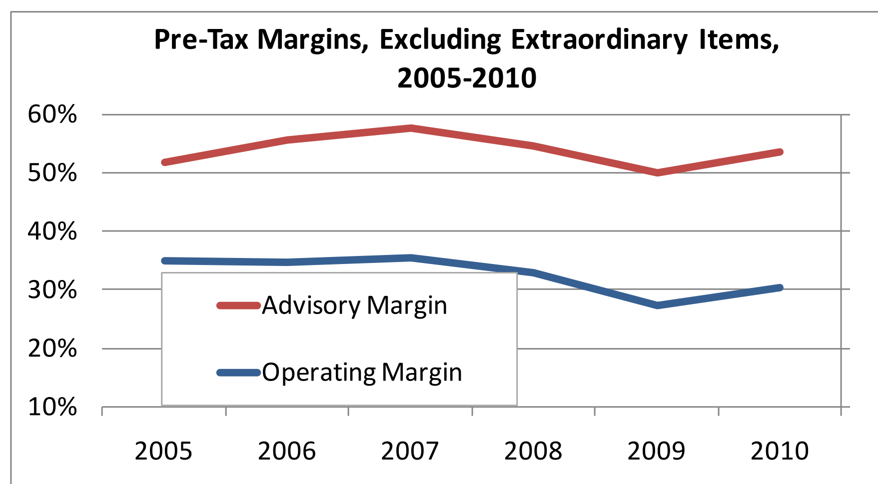
Industry Profitability Returns as Average Assets Rise in 2010

By C. Meyrick Payne and Sara Yerkey of Management Practice Inc. (MPI)

The most important function performed by mutual fund trustees is the annual review of investment management arrangements. One of the factors in this review is the analysis of the investment manager's profitability. The Jones vs. Harris case has reinforced the contract renewal process that has been conducted for the past 30 years, and has emphasized that the assessment of the advisor's profitability remains a necessary step.

The procedure trustees follow to review profitability is critical and should have some benchmark against which to evaluate profitability. MPI has tracked the pre-tax profit margins of publicly traded companies significantly engaged in mutual fund management. The range of individual margins varied, however the average return after all costs, before taxes and excluding extraordinary items, was generally about 30% of revenue. In contrast, the advisory margin averaged closer to 50%. These trends are shown in the chart below.



MPI's analysis concluded that average annual assets had returned in 2010 from the dramatic decline in 2008. In addition to greater assets, higher revenues and resulting margins were also the result of an increase in advisory fees due to an asset mix shift away from more risk-averse products, such as money market funds and ultra-short bond funds, to more adventurous fixed income and equity products. Furthermore, the asset mix returned to a greater percentage of retail clients, which often show a higher advisory profit, but not necessarily operating margins.

In 2010, there were several factors which kept margins lower than might have been expected. First, firms that had the majority of their assets in money market products experienced a large outflow of assets and often had to implement voluntary fee waivers in order to maintain positive yields. Second, higher bonuses and investment in technology and infrastructure after a two-year freeze eroded potential increases. Lastly, the 2010 margins would have had a more significant increase compared to 2009, but in 2009 many firms recognized one-time extraordinary items, reducing the expense component of their margins. Including these items, the 2009 margins would have been significantly lower.

Measuring and monitoring profitability on a fund by fund basis is also important because the trustees represent shareholders of each individual fund and because the Gartenberg ruling emphasizes the importance of individual fund review. Fund profitability is typically based upon the advisory fees and the corresponding expenses alone, whereas the complex-wide operating margin is measured on the basis of all investment management activities, including marketing and shareholder services.

MPI's analysis of advisory margins shown above corresponds to those referred to in the Gartenberg line of cases, where a "guideline" margin of 77% was established. In our 2010 analysis of 18 public companies where we could obtain roughly equivalent information, we found that the average profitability on the advisory contracts had increased to 54% and the operating margin for those companies was 31%.

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The complete analysis including ten years of operating and advisory margins, underlying participant detail, product and asset trends and profitability drivers are available by contacting Management Practice.

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MANAGEMENT PRACTICE®

The Search for New Fund Directors

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

MPI's last bulletin discussed the effectiveness of mutual funds and their governance model during the recent economic upheaval. It stressed the importance of mutual fund boards as well as the prospect of their getting more attention as a new financial regulatory structure is laid out. While much is still to be determined, it is likely that there will continue to be a need for highly qualified individuals to serve as independent directors to help oversee America's mutual funds, exchange traded funds, and potentially even hedge funds.

The total number of independent fund directors in the US is approximately 2600, serving on around 600 boards. Tenure for directors is often about 20 years, which would suggest that only 130 positions or so open up each year. While that is a relatively small number, it does not mean that qualified and interested individuals shouldn't investigate the possibility of pursuing a directorship. The fund industry should (and does) attract the best, brightest, and most qualified candidates. Being elected as a fund trustee is a desirable position. It provides one with a sense of duty, intellectual engagement, and broader financial experience, as well as compensation that can range from less than $20,000 to up to $200,000 and beyond.

Here are some issues for prospective directors, as well as current directors charged with filling a board slot, to keep in mind during the search process:

- **Specific skills** – A significant trend has been the shift by some boards to recruit experts in particular subject areas, such as compliance, derivatives, valuation, or best execution. We call this the "T-Shaped" director: one who has a broad business background, as well as deep expertise in a particular financial field. Aspiring directors with specific skills would do well to highlight them when approaching boards. And nominating committees should seek to understand gaps in the current board skill sets which will be needed to govern in the next 5 to 10 years.

- **Availability** – Serving on a board can be very time consuming. Directors must be available for all board meetings. While 4-5 per year is still the average, many boards, particularly at large fund complexes, meet from 7 to 12 times per year. In addition there are often committee meetings as well as the possibility of special meetings called due to specific, unexpected issues. Meetings are not optional, regardless of the compensation structure. If a director is unable to attend virtually all meetings, he/she should step down. Preparation is also of utmost importance, with the board materials typically arriving a week or two before each meeting. These materials can sometimes be measured in feet rather than inches. There is a need to stay current with industry developments through continuing education. Many directors make a point of attending at least one industry conference per year.

- **Location** – The majority of meetings are held in boardrooms, so proximity to the meeting venue is important. Long distances can add significantly to both the time and expense required for serving on the board.

- **Communication** – Directors must be willing and able to express themselves to the rest of the board, as well as to management and other parties involved. Directors help no one by keeping their thoughts to themselves; conversely directors who monopolize meetings are equally ineffective. Communication can be in person, by telephone, or often via email.

- **Previous board experience** – While rarely a requirement, past experience serving on another board (corporate, charitable, etc.) can indicate to both the board and the candidate that he/she has what it takes to serve. Conversely if a candidate is on too many boards, there may be a question of availability. Serving on more than one mutual fund board, while allowed, may be seen as a conflict, particularly if the fund groups compete for shareholders, distribution, or human resources.

- **Conflicts of Interest** – Conflicts are a major issue, touching upon numerous subjects that range from personal investments to family member employers. Candidates must confirm that there are no current conflicts, and be prepared to resolve them or step down should one present itself. When a fund group has many sub-advisors or serves as a sub-advisor, the "umbrella of potential conflicts" is surprisingly large.

- **Familiarity** – It is helpful to have a candidate who is familiar with the fund complex—not specifically with the advisor or its management—but rather an understanding of the structure and history of the fund family. A minimum personal investment in the funds they oversee is a common requirement for directors, as it illustrates that they share interests with shareholders.

- **Chemistry** – Finally, as with most organizations, there needs to be a personality fit among the board members. While directors don't have to be close friends (and perhaps shouldn't be), meetings are long and the issues are critical, so a positive, well functioning working environment is important.

Connecting Candidates with Boards

Candidates and boards find each other in various ways, and those interested in finding a position on a mutual fund board have a number of options. Visiting the websites of the Mutual Fund Directors Forum or the Independent Directors Council is one way to get started. A few of the board headhunters/executive search firms also look for fund directors. Any contacts with fund industry participants could be helpful in getting one's name out in front at the right time. Direct contact with the nominating committee chair of a fund might also prove effective.

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Management Practice, Inc. consults for mutual fund boards and has assisted many boards with the trustee search process. MPI also publishes "The Uneasy Chaperone" which describes the director's job in greater detail.

Building a Process to Recruit a Diverse Fund Board

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

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 in terms of diversity, whether this includes education, profession, risk orientation, income, motivation for investing, and family size and aspirations 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 in fact 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[1] 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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[1] 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 currently have a mandatory retirement age and 72 is the most frequently reported age. 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 as well as diversity process counseling to mutual fund boards.

MANAGEMENT PRACTICE®

Measuring the Effectiveness of Fund Boards

By: C. Meyrick Payne and Sara D. Yerkey of Management Practice Inc. (MPI)

Every year fund directors undertake a carefully conducted but somewhat subjective board effectiveness evaluation. Typically, counsel to the independent directors administers a well-honed questionnaire about independence, preparation and attendance. The directors often confidentially review their own performance in addition to the board as a whole. The process creates an opportunity for discussion and ultimately the strengthening of the board, benefiting the fund shareholder. The addition of tangible measurements, which are not commonly used, can give further insight and enhance the evaluation experience. This bulletin explores a quantitative focus for measuring fund board effectiveness.

CRITERIA AND MEASUREMENT FOR BOARD EFFECTIVENESS

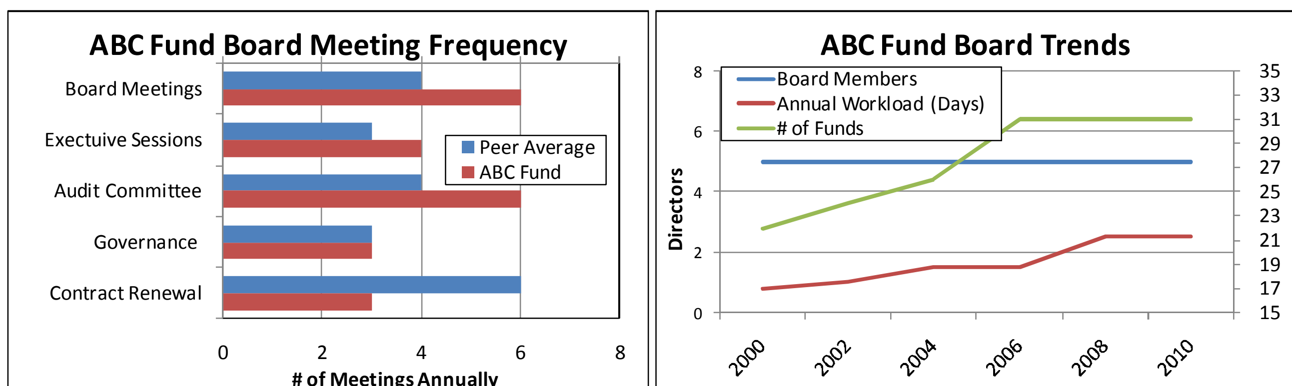
Boards initially dedicate significant effort establishing their structure to support the fund shareholder, but how effective are the current structure and procedures in continuing to support the fund shareholder interests? The annual board self-assessment requirement implemented by the SEC in 2006 attempted to ensure that this question was being addressed. Using tangible tools in the annual assessment allows for a more productive and efficient process.

In addition to assessing their own performance, it is often helpful to have industry benchmarks for directors to gain perspective. The criteria for a board to be successful should be well defined, long term, and focused on supporting aspects of governance over which the fund directors have control. The following list highlights some of the criteria for which quantitative benchmarks are available from the ICI/IDC or MPI Annual Fund Director Compensation and Governance Surveys.

Historical trends and comparative benchmarks are available for:

- Director independence
- Board compensation, individual and aggregate
- Frequency, length of meetings and hours of preparation
- Number of board members
- Number of funds
- Board investment in the funds
- Continuing education hours
- Committees created/disbanded

Examples of the types of charts that might be used to track objective criteria follow:



In addition to historical trends and statistical measures, there are items that can be mapped to facilitate further board assessment discussions:

- Age distribution and retirement schedule maps (if applicable)
- Assessed skills or diversity needed over time and board members hired or skills acquired to fill need
- Streamlining board materials or technological improvements for meetings

ALIGNING SHAREHOLDER INTERESTS

While the overall strength of the board is in the direct interest of the fund shareholders, and the qualities previously discussed are imperative factors in this strength, fund shareholders are also interested in how their directors are monitoring their investments.

Within the 15(c) process, directors are responsible for reviewing the comparative performance and expense ratios of the funds they oversee. While the directors have an oversight (and not daily management) role over the funds, the long-term performance reflects their overall effectiveness – certainly in the eyes of the fund shareholders.

With regard to expenses, by looking at the trends over time, directors can observe realized and potential economies of scale, and determine whether their actions have been effective in maintaining a competitive and fair fee structure for the shareholder.

Shareholders want their fund to stay true to the investment style they chose, and they do not want higher expenses dragging down their fund's performance. Other impacts to the expenses (and directors' responsibilities to review) are the merging, opening, and closing of funds, as well as new share classes. One of the great hidden drags on fund performance is the brokerage that funds pay to transact portfolio changes. As a result, fund directors have an explicit responsibility to monitor "best execution".

A trailing look of year-to-year change in three- or five-year performance is a possible basis of evaluation for directors to evaluate their oversight abilities. While this will be impacted by a fund's risk tendencies, industry exposure and other prospectus disclosures, funds that remain in high or low quartiles consistently over time make a definitive statement about the performance of a fund board.

The difficulty with the typical fund director evaluation today is that (1) it is carefully constructed, but still arbitrary, (2) it measures aspects of governance that are of little immediate interest to fund shareholders and (3) often does not provide tangible measurements that highlight areas of possible discussion.
The addition of some quantitative objective metrics would greatly improve the measurement of fund board effectiveness.

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MANAGEMENT PRACTICE®

Working to Improve a Fund Stewardship Grade

By C. Meyrick Payne and Jay Keeshan of Management Practice Inc. (MPI), a professional firm which offers governance services to mutual fund boards.

Most fund directors are aware that Morningstar assesses the governance and ethics of mutual funds by assigning a Stewardship Grade. This process was started about five years ago but has recently been rejuvenated and reemphasized. Morningstar's overall intent with the grades is to "shine a light on better/best practices." They have currently rated about 1,000 out of 7,000 funds representing about 30% of all fund assets.

The rejuvenation of this grading stems from the fact that Morningstar has proven, to its satisfaction, that Stewardship Grades are highly correlated with their better known Star Ratings. Of course, the Star Ratings have been an important factor in the growth of a fund's assets. The Stewardship Grade is a consideration which potential investors might want to take into account.

During five years of producing the Stewardship Grades, Morningstar has refined the criteria which go into them. For example, when the grades were first introduced the number of funds governed by a single board was a determinative factor; the more funds governed, the lower the grade. This has been changed from an absolute criterion to one which is taken into account along with numerous other variables. This provides an example of how subjective the Stewardship Grades can be and how important it is for fund groups to take an interest in how these grades are assessed.

Virtually all of the criteria Morningstar uses for its well-known Star Ratings are quantitatively measured. The investment category into which a fund falls is predominantly determined by objective criteria such as the price earnings ratio and the capitalization of the underlying investments. For fixed income funds it is determined by, among other things, the duration of the underlying bond and the credit quality of the issuer. With these quantitative measures there is not much to argue about. However when there is, investment managers spend a great deal of effort to ensure that their fund is fairly rated and placed in the appropriate category.

With Stewardship Grades, more subjective judgment goes into Morningstar's assessment. Fund boards should take a lot of care to obtain the best possible rating and to present the facts about their funds' governance in the best possible light. Morningstar makes a point to be available to discuss particular grades. They are always interested to learn how fund directors interpret the elements which are taken into account by their analysts when compiling each grade.

The criteria that Morningstar uses to determine Stewardship Grades include (1) corporate culture, (2) fees and expenses, (3) board quality, (4) manager incentives, and (5) regulatory issues. To arrive at a Stewardship Grade, points are tallied across all five components. The maximum score is 10 points. The numeric score is then converted to a letter grade in a process that weights relatively good performance among other funds that have been similarly graded. The components of the Stewardship Grades are discussed below.

- Corporate Culture This is the highest scoring component with a maximum of 4 points. Morningstar looks for a history of putting the fund shareholder's interests first, particularly whether small individual shareholders receive the same treatment as large institutional shareholders. The rapidity and frequency of management changes are an important consideration as are any regulatory or legal scandals. Rapid trading patterns are a consideration especially if the manager has an affiliated broker dealer. Another indication is the clarity and precision of the prospectus language. Morningstar seems to be particularly interested to see that market timing is discouraged through the adoption of short-term redemption fees.

- Fees (and Expenses) Fees, board quality, and manager incentives each carry a maximum score of 2 points. Fees and expenses are evaluated by reference to a fund's peer group of similarly sized funds (usually categorized within the same Morningstar Style Box). Typically Morningstar compares average effective management fees, or the initial or starting management fees. The sharing of economies of scale through the existence of break points in the management fee as assets in the fund rise is an important consideration. The total expense ratio compared to a fund's peers is very important as is the degree to which expenses are voluntarily capped.

- Board Quality The span of control of the board is a consideration in this component as is the relationship of the individual directors to the manager. For example, independent directors who are former executives of the management tend to be frowned on. The existence of an independent chair is deemed a virtue as is a record of standing up to the management company over issues which impact the fund shareholders. Compensation substantially in excess of directors of similar funds or the existence of retirement benefits tends to detract from this component. Sensible mandatory retirement ages or term limits may be viewed as a virtue. A practice of directors investing in the funds they govern is desirable.

- Manager Incentives Morningstar believes that the absolute amount and structure of compensation of the portfolio managers and other key executives is an important consideration. The absolute amount of compensation should be high enough to ensure that high quality executives are attracted, motivated, and retained. Compensation through base pay, bonus, and equity-based pay should be structured to ensure that fund executives are motivated to serve the fund shareholder well. Too great an emphasis on management company profits may detract from the motivation to deliver better than average returns to the fund shareholders.

- Regulatory and Legal Issues Scandals, adverse regulatory and legal settlements, and even unflattering press coverage may detract from this component of the Stewardship Grade. Furthermore the manner in which such settlements are made can indicate whether or not the manager actually embraces transparency.

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MPI offers consulting services to fund boards that want to better understand their Stewardship Grades or seek to improve them.

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