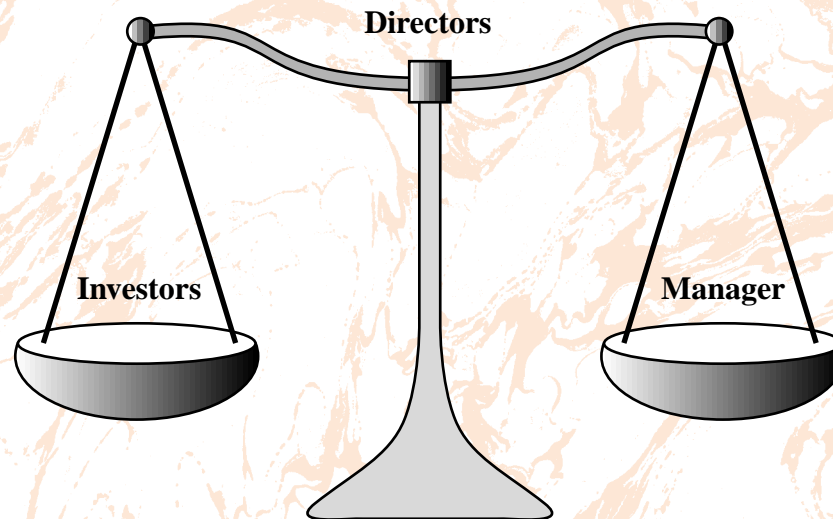


# Strengthening Mutual Fund Governance

A RESEARCH REPORT AND DISCUSSION PAPER



*Keeping the balance . . .*

**M**ANAGEMENT  
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# Strengthening Mutual Fund Governance

This Management Practice Inc. (MPI) discussion paper suggests improvements to mutual fund governance that are both effective and yet not so drastic as to erode the industry's entrepreneurial vitality. These suggestions are not meant to be definitive. They are offered as a starting point for further debate. This paper is divided into three parts.

- **"The Case for Stronger Governance"** looks at the opportunity for growing mutual fund assets partially as a result of better governance or, more precisely, better marketed governance. This part also summarizes the problems with the current system in a way that clarifies potential solutions.
- **"Suggesting Legislative and Regulatory Solutions"** suggests ways to capture the opportunities for future mutual fund growth and solve the problems with the present governance structure.
- **"Marketing Governance and Best Practices"** assesses the impact of a marketing effort to heighten the investing public's awareness of the directors' role as well as the adoption of a set of "best governance practices".

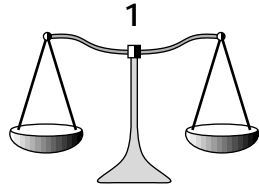
This series concludes that the changes needed are comparatively small. The difficulties with implementing them seem substantial; especially to those who have been successful under the present system. When viewed against the opportunities for growth in an age of greater individual responsibility for retirement, the suggested changes seem quite mild.

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Management Practice, Inc. is a New York based consulting firm specializing in issues of Mutual Fund Governance.

This white paper was drafted in February 1999 for the Securities and Exchange Commission Roundtable Conference on Mutual Fund Governance. The paper was modified in March as a result of the conference.

This white paper was prepared as a syndicated research study. The resulting report is priced at \$3,800 for fifteen copies; included in this price is a personal presentation and discussion by the author to your Mutual Fund Board or Governance Committee.



# The Case for Stronger Mutual Fund Governance

There are potential benefits from better mutual fund governance as well as a need to correct current problems in the structure.

## THE OPPORTUNITY FOR BETTER GOVERNANCE

The next \$5 trillion in mutual fund asset growth is, in many ways, tied up in the individual's responsibility for retirement and medical care savings. The growth may come in the form of 401(k) savings or individual investment of privatized social security. In either case, growth will increasingly come from the savings of middle and lower income groups rather than the investments of the well to do. Just as ERISA placed a higher standard of oversight on pensions in the 1960s, legislation concerning the privatization of social security will do the same for mutual fund governance.

The alternatives for strengthened oversight come in many forms. The public, the Congress and industry have no tolerance for a new government bureaucracy. The fund industry, like any other, would prefer self-regulation administered through fund based boards of directors, which can take into account the specifics of each situation. However, the essential assumption must be that each board operates in a professional, independent, and expert way to a recognized standard of excellence embraced by the industry as a whole.

Mutual fund governance is an underutilized resource. There are currently about 3,000 independent directors overseeing 9,000 funds, more companies than are listed on the New York Stock Exchange, and \$5 trillion in assets, nearly as much money as resides in the US commercial banking system. The banks are overseen by as many as 40,000 Federal and State regulators. The fund industry has had problems, but not a single debacle, while the savings and loans industry, highly regulated, endured a \$500 billion bail out in the 1980s.

In our firm's annual studies of mutual fund director compensation, we find that each director is paid about 10 cents for each \$1 million over which he or

she stands guard. Compare that to the cost of installing and operating an electronic surveillance system in a million dollar home.

Perhaps the worst thing that could happen to mutual fund governance as a result of press criticism and SEC review, is to dismantle it. Some will argue that it is too flawed, too expensive, and too intrusive. Nothing could be further from the truth. Governance needs improving, not dismantling.

## STRONG VERSUS WEAK DIRECTOR MODEL

Before this paper dives into the problems and possible solutions to governance problems, a discussion of appropriate model for mutual fund directors is needed.

Many industry professionals argue that the marketplace provides the primary check and balance on the conduct of mutual funds. By definition an investor can sell their shares and walk away. The logic follows that directors are a secondary check and balance and need not be empowered with reinforced authority. This "weak" model for directors gives them the responsibility to cry wolf when they see something amiss, effectively warning the shareholders and, in the ultimate, forcing a proxy vote.

Contrast this with the "strong" model, where the directors become the primary check and balance. In this model the shareholders look primarily to the directors to negotiate on their behalf and to see that the fund runs well. The investor may still choose to sell, but his or her primary safeguard is the directors.

The "weak" model may well have been correct in the past. The money in mutual funds was primarily the investments of relatively well to do people; in the future the money may well come from the retirement savings of middle or lower income groups. In addition the ability to sell a fund is complicated by the built up capital gains in the funds. Selling out usually comes with a price of increased taxes. The "strong" model may well be more appropriate in the age of privatized social security.

The principle difference between the two models comes down to the directors' authority to negotiate the management fee. Negotiate does not necessarily mean secure the lowest possible; it may mean a performance based fee, or a base fee with an override. But it does imply that the directors have the right to cancel the advisory contract and appoint a new advisor without the need to secure a majority of stockholder votes. Under this model if the investors do not approve of the actions of the directors then they sell their shares.

## Principle Mutual Fund Governance Problems and Possible Solutions

Governance Problem	Primary Solution	Comment
Lack of public and investor knowledge about the role and benefits of mutual fund directors.	Implement awareness program and publicity about benefits of mutual fund directors.	ICI is capable and has resources to advocate the benefits of independent directors, particularly as part of a program of individually managed privatized Social Security
Investor indifference to fee and expense levels.	Disclose (1) expenses as percent of gross fund return in periodic bar charts and (2) an after tax performance return assuming a standard individual rank profile.	Varies widely by fund type and period, but clearly focuses investors' attention on comparative impact of high expenses and valuable aspects of portfolio trading.
Insufficient director independence	Increase the percentage of outside directors to 75% of a fund's board.	Bank funds already have a 100% independent director requirement and all funds have a 75% safe-harbor requirement following a merger.
Directors' inability to enforce their decisions in a proxy battle.	Require 67% of stockholders of record to prevent a change of manager or to remove a subsequent interim manager.	Provides directors with much greater ability to prevail in a dispute with current management. Provides greater comfort to interim managers to accept the appointment.

### PROBLEMS WITH GOVERNANCE TODAY

Mutual funds have become sophisticated branded products, mass marketed through a multiplicity of distribution channels. As a result, consumer perception has become reality. Like it or not, perceived weaknesses in governance rapidly become real impediments to marketing. Horror stories, real or imagined, in the financial press damage the entire industry.

Every week the financial or popular press writes an expose of some governance problem usually in the corporate world but occasionally in the fund world. In the corporate world, the SEC unearthed ineffective or inefficient boards of public corporations; strike suit lawyers sought remedies in court; CALpers and

other large institutional investors set investment criteria for good governance; advocacy groups raised objections and proposed resolutions at stockholder meetings. In response corporate directors formed a trade association to set best practice benchmarks. Mutual funds are close behind.

Although the laws theoretically provide sufficient power for the directors to do their job, there are practical problems. These fall into four categories, (1) lack of public and investor knowledge about the role and benefits of mutual fund directors, (2) stockholder indifference about fund fees and expenses (3) insufficient director independence and (4) directors' inability to enforce corrective action. Although discussed in detail, below the primary solution to each problem is suggested in the chart shown on page 6.

### Lack of Public Awareness of Directors' Importance

The directors, as a group, have never marketed themselves. In an age where the brand of a particular financial institution is the dominant consumer driving force, the directors have little chance of gaining influence if the retail customer does not know what they do or the benefits from their existence. In two recent proxy battles, Navellier and Yacktman, it became clear that investors were unaware of the role that independent directors play. By comparison with the public relations and market power exerted by the manager, with whose brand the funds are identified, the directors have no chance to prevail. If this imbalance is not corrected there is doubt that the directors will ever be able to be an effective watchdog for the investors.

The Investment Company Institute is the logical organization to provide marketing and professional support for the directors of the organizations for which the Institute is named. Failing that, mutual fund directors may be obliged to form their own equivalent of the National Association of Corporate Directors. In our firm's opinion the industry would not be well served by splitting its Washington representation at a time when so much is at stake in the possible privatization of Social Security.

### Shareholder Indifference to Fee and Expense Levels

In the bull market of the past six years investors have become quite insensitive to fund fee and expense levels because, as a general rule, they have done very well. Expense ratios seem comparatively low and investors understand that investment managers deserve to be highly compensated for a job well done. With this as a prevalent attitude, expense comparisons may appear reasonable even though the absolute levels are high.

Part of the problem is that fund expenses are typically shown as a percent of fund assets, a very large denominator. This disclosure portrays an annual outflow of money as a fraction of a large period end balance—not unlike General Motors disclosing its operating expense as a percent of its year end total assets. Even the disclosure of how many dollars an investor will pay in expenses per \$10,000 invested is not particularly meaningful to an individual investor. Shareholders would be more interested in the expense ratio if it were shown as a percent of what they earned in the same period because then they would see how much of their return has been eroded.

## Insufficient Director Independence

In our firm's experience, by far the majority of directors maintain a truly independent perspective and work hard to ensure that the interests of the shareholders are protected. Nonetheless the industry has a responsibility to police itself. Correcting the inevitable abuse is in everyone's interest.

Where there is insufficient director independence, it may be evidenced in any one of four ways:

**1. No or insufficient breakpoints as assets rise.** The assumption implicit in the very existence of 12(b)-1 distribution fees is that the fund expenses should decline as assets rise; while our firm's experience is that many directors work hard to pass these economies along, they rarely match the actual incremental benefit of asset growth. Except in the rarest cases the expenses associated with an incremental influx of funds are proportionately minimal to the revenue earned. In addition directors often do not interpret suggested scale downs in the management fee in dollar terms. A five basis point scale down on a 70 basis point management fee over \$400 million, represents a \$200,000 give up while the management fee rises \$2,600,000 or about 7.5%. The expenses of managing an additional \$400 million are unlikely to approach \$2.6 million.

Even this example rarely reflects reality. A new scale down is likely to be set at some asset level that has not yet been achieved. If, for example, the new break point is set \$200 million beyond today's asset level, the manager will earn an additional \$1,400,000 per year before the new scale down level is reached. This reduces the manager's fee concession to \$200,000 as a percent of \$4,000,000 or 5%. From the manager's viewpoint, break points in the management fee are relatively painless particularly considering the small cost increase that results from managing marginal growth in assets.

Even when the directors actively review the scale down of the management fee, they rarely consider it in the context of alternate providers. When a large

institution seeks competitive bids for investing substantial sums of money, the price is likely to be in the range of 40 to 50 basis points. Fund directors rarely impose this level of scrutiny because they never think of competition at the fund level. Indeed the Vanguard group of funds negotiates advisory fees with its sub-advisors for actively managed equity funds at an average of 15 basis points.

**2. No realistic review of the profitability of the funds' contracts to the management company.** Every industry professional expects that the advisory contract will be quite profitable, in the range of 30 to 70 percent of revenue. Exactly where depends on the size, age and complexity of the particular group. Nonetheless this level of profitability is substantial given the high level of compensation paid to the senior executives of the Management Company.

The economic risk associated with the mutual fund business lies in two areas: (1) unsuccessful new funds and (2) unrecovered distribution expense. Profits from successful funds certainly have to be sufficient to reward these. Judging from what premium companies are prepared to pay for an established investment manager, the market certainly seems to reflect that the profits justify the risks.

**3. Little or no sharing of windfall profits in the event of a sale of the Management Company.** Few industry professionals would doubt that the manager has proprietary rights in the funds managed. When the Management Company is sold, it seems just that the owners should receive the lion's share of the proceeds. However the fund directors should negotiate some sharing of the windfall, so that the underlying investors, whose contract is to be transferred, share in the gains.

When Management Practice first started to track the purchase price of investment management firms in 1994/95, the average price was about 2% of assets. For example Morgan Stanley paid \$1.26 billion for the \$57 billion VanKampen complex. By 1996/97 Franklin Templeton paid nearly 4%, or \$610 million for the \$17 billion Heine Complex. In 1999 the Phoenix Insurance Company paid over 6% for the \$2.5 billion Zweig Complex and then retained the Zweig firm as sub-advisor at approximately a 10 basis point fee.

**4. No comparison of fund performance with separate accounts managed by the same advisor.** Fund performance is usually measured against other mutual funds of the same investment objective. However, directors might be well served by comparing performance with similar separately managed accounts. This would help the directors understand the impact of mutual

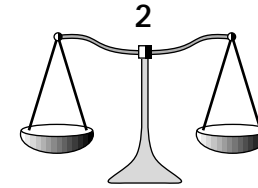
fund expenses and provide a way to scrutinize the allocation of preferred investment opportunities, such as rights issues and initial public offerings.

The independence of directors has much to do with their frame of mind. Some changes which focus their attention on the needs of their stockholders seems justified.

### Directors Inability to Enforce Decisions

The dirty little secret of mutual fund governance is that directors have little authority to enforce their decisions. They have the statutory strength to force a disagreement to a stockholder vote but virtually no chance to win in a proxy fight. In fact, the directors are set up to fail.

Some say that the directors have done their job if they bring their concerns to the attention of stockholders. Should a majority of stockholders vote in favor of the manager then so be it. Others argue that their right to sell their shares protects the stockholder. This does indeed protect the well-informed individual but does nothing for those remaining or the fund as an entity. In addition, forcing an investor to sell may produce significant taxable profits. The directors' job is to look out for the stockholders collectively. An individual's remedy is not a collective remedy. The directors' inability to prevail is doubly damning because the investors have the illusion of protection when, in fact, little exists, beyond the ability to cry wolf—albeit loudly.



## Possible Legislative and Regulatory Solutions

In this section we suggest several structural solutions to strengthen mutual fund governance; these include structural, voting and disclosure changes.

### STRUCTURAL CHANGES

Some suggestions for structural changes include:

**1. Seventy five percent disinterested directors on the board.**

Increasing the percent of outside directors on mutual fund boards to 75% would be a useful, and not very painful, change. At present most complexes have a 12b(1) fee in-place which increases the required percentage to 51% from the standard 40. In addition, the safe-harbor rules which apply to a mutual fund board following a merger, already require 75%.

A side benefit is that this increase in independent representation might make it easier to correct an important directors' insurance problem. In the recent Yacktman dispute, it became clear that the standard directors' and officers' insurance policy specifically excluded disputes between the independent directors and the inside directors. The insurance carrier does not want to be liable for legal and other costs from both sides of the same dispute.

The objection to this change is that it might deter innovation in the industry. No sponsor of a new fund wants to feel at the mercy of a group of "disinterested" directors. However, there has been no shortage of innovation in bank sponsored funds where this rule is already in place.

**2. Independent directors as chairman.** This change goes a long way toward strengthening the independent directors' ability to control the agenda.

**3. Term limits for directors.** Fresh thought is brought to the board whenever a new director is elected. Perhaps nine years would be a suitable term

limit. The objection to this change is that it could deprive funds of experienced directors. However, nine years is probably sufficient, particularly if board members are grouped into overlapping three-year classes. Term limits could be set at the fund level, so that a director might rotate from one cluster which governs, for example, equity funds to another which oversees fixed income funds.

An alternative to term limits is mandatory retirement at a specified age. According to our firm's 1998 director compensation survey about 40% of fund groups have mandatory retirement policies and the most frequent age is 72. Many older directors are vibrant members of the board. Also many mutual funds are owned by older Americans and younger ones often own them as a way to save for retirement. As a consequence term limits may be a better alternative than mandatory retirement.

**4. Annual meeting of shareholders.** Few funds have annual meetings, as state law rarely requires them. Unfortunately this means that directors become removed from their core constituency; and they from their representatives. The objection of cost has little validity because Fund annual meetings could be clustered together and video transmission used to broaden participation.

## CHANGES IN VOTING REQUIREMENTS

An additional change may be needed to give the directors more authority to enforce their decisions. As described above, the directors invariably lose in a proxy contest because the shareholders are, by definition, either strong supporters of the Management Company or uninterested in the dispute. This is particularly true where advance publicity has given shareholders plenty of time to sell before a proxy vote occurs. It is the certainty of eventual defeat in a proxy fight that deters the directors from taking corrective action; thus adding to the illusion of investor protection.

A voting requirement of two thirds of stockholders of record to prevent the change of manager or to overturn the appointment of an interim manager might be a useful change. This change would greatly strengthen the authority of directors, but would not give absolute power to run roughshod over the manager. As the law currently stands, directors find it virtually impossible to persuade an interim manager to take over because it will most probably fail to win the subsequent proxy. Partially as a result, any action taken by the interim manager is subject to all manner of second guessing and lawsuits.

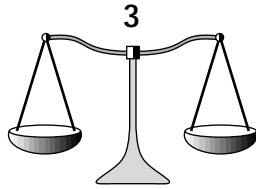
## IMPROVED FEE AND EXPENSE DISCLOSURE

Finally improved fee and expense disclosure would heighten shareholders' sensitivity to the directors' ability to control costs. Some possibilities include disclosure of:

**1. After-tax rate of return.** Since each investor is liable for the tax on the fund's net gain, the disclosure of the after tax return is useful information. Actual after tax return differs according to individual circumstances of each shareholder and, for many whom have their holdings in tax-exempt retirement accounts, after tax return is not meaningful. Nonetheless use of a reasonable tax profile allows for inter fund comparisons.

**2. Expenses as a percent of total return.** One of the most effective ways to encourage investors to focus on expenses is to quantify their impact on return. Of course the erosion of return varies greatly by fund type and will be quite different from year to year. This impact could be shown as a quarter by quarter or year by year bar chart. The intent of this change is to heighten the shareholders' awareness of fees and expenses and thus to demand more accountability from directors.

In addition to legislative and regulatory changes, there are marketing changes and adoption of best practices that will improve fund governance.



## Marketing Governance and Best Practices

A substantial marketing effort on behalf of directors, intensive support for the directors cause from the SEC as well as the adoption of best practices are needed if the current governance problems are to be solved.

### PERCEPTION AND PERSUASION

During Arthur Levitt's Chairmanship of the Securities and Exchange Commission, he and successive Directors of Investment Management have jawboned hard to keep mutual fund directors focused on safeguarding the interests of stockholders. In speech after speech the SEC has chided directors to be sharp and steadfast in the investors' cause. In examination after examination the SEC inspectors have emphasized independence and demonstration of a record of well-informed business judgement. For those who fall foul of the regulations, the SEC has been swift to set an example. The SEC's much publicized round table on mutual fund governance once again reminded directors of their responsibilities.

The press has also played an important role in bringing questionable practices to light, particularly where an action is technically correct but practically dubious. The SEC's requirement to disclose the aggregate amount of director compensation from a complex provided the press with ammunition to question the effectiveness of directors.

Needed more than anything else, however, is more powerful marketing and professional support for directors from the Investment Company Institute. The ICI has the structure, resources and platform to do the job. In addition, in our firm's opinion it is a far better alternative than creating a separate director organization in Washington.

### BEST GOVERNANCE PRACTICE

At present the mutual fund industry has done little to codify best governance practices. Some of the best analysis of the possibilities comes from adaptation of the corporate governance guidelines established by CALpers and the National Association of Corporate Directors, among others. The following policies seem particularly important:

**1. Separate counsel for directors.** The responsibilities of the directors are quite distinct from the Management Company and, in some cases, from the Fund itself. The directors need to be guided in the execution of their unique responsibilities to ensure that they never lose sight of the stockholders whom they represent.

**2. Third party analysis of fee, expense and performance comparisons for contract renewal.** The directors should have an independent source of peer group analysis for renewal of the contracts with the Management Company. The use of an independent third party provides a much-improved record of prudent business judgement.

Ten years ago, it may have been sufficient to use independently compiled comparisons from a single data source. Today mutual fund performance and expense comparisons are much more complex. The devil is in the details. Peer group selection, choice of the appropriate index, comparisons with other investment vehicles and multiple data sources are all-important parts of assessing performance, risk and expense control.

**3. Access to stockholder complaints.** By routinely analyzing communications from stockholders the directors can monitor praise and complaints about returns, risks, service, expense and management fees.

**4. Board clusters for reasonable span of control.** Investors become skeptical of a director's ability to govern an endless number of funds. Even if the board itself has an excellent staff and process in place to highlight problems, stockholders can not conceive that directors can govern hundreds of funds. As a result, boards might consider splitting into clusters when the span of control becomes excessive.

**5. Continuing education for board members.** Virtually every profession requires its members to complete continuing professional education. The credibility of the governance process is enhanced if investors know that directors are held to high educational standards. By attending conferences and semi-

nars together, directors share experiences and solutions to common problems. Having a line item budget for continuing education ensures that directors are reminded of their responsibility to stay fresh and independent.

**6. Director's investment in the funds governed.** Just as in public corporations, shareholders become concerned when directors do not own shares in the funds that they govern. Mutual fund directors should own shares in each type of fund managed by the complex for which they serve as a director.

**7. Annual self-assessment of independence.** Each director should complete a formal self-assessment of personal independence from the management company based on criteria set by the board as a whole.

Over time, the fund industry will need to develop more comprehensive benchmarks for best governance practice. Mutual fund governance has worked well for the past fifty years. Some improvements are needed for the next fifty.

Throughout this discussion paper we have tried to avoid suggesting changes which would impact the entrepreneurial character of the industry. After all the industry has been uniquely successful at creating wealth for millions of Americans. However, the next \$5 trillion in mutual fund assets will come from savings rather than investments. The industry should embrace a limited number of changes as part of a plan for attracting those new savings.

If you wish to learn more of our firm's capabilities or research, please look at our website, [www.MFGovern.com](http://www.MFGovern.com), or call us at 212-867-7948.

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