

Mutual Fund Boards on Governance – Do As I Say Not As I Do

by John Okray¹

Corporate governance practices that mutual fund directors have imposed on corporate directors are much more onerous than those they have implemented for themselves. This paper explores this dichotomy. As of October 2013, U.S. mutual funds had over \$14.6 trillion in assets.² Depending on how they are structured, mutual funds have boards of directors or trustees that oversee the most important aspects of the fund. These responsibilities include maintaining a fund's governing documents, hiring and oversight of the investment adviser and other service providers, approval of the fund's major policies and plans, oversight of the valuation and proxy voting of fund portfolio securities, and signing the fund's registration statement (i.e. prospectus).

Director Elections

When it came to voting for corporate directors, many mutual funds had historically been very deferential to company management in supporting its slate of candidates. In his address at the Investment Company Institute's meeting in 1978, Harold Williams, then Chairman of the U.S. Securities and Exchange Commission ("SEC") asked "How can corporate accountability and the substantive merits of shareholder participation be realized if the largest and most sophisticated shareholders abdicate the responsibilities that go with ownership?"³ This unmitigated concern was later addressed by the SEC when in 2002 it required mutual funds to publicly disclose how they voted on the proxy voting proposals for companies held in their portfolios.⁴ Mutual funds held 18% of all U.S. public company equity at the time. Because of their size, many mutual fund complexes often represent the largest individual shareholder of a public company and therefore wield an enormous amount of influence.

Corporate scandals, outrageous executive compensation not tied to company performance, excessive perquisites, huge golden parachutes, and other repugnant practices came to the attention of lawmakers and shareholders which more recently put scrutiny on mutual funds proxy voting practices. Perhaps of more importance was the fact that poor corporate governance practices were negatively impacting fund performance. As a result, there have been a number of changes in how mutual funds are holding corporate directors accountable.

Election Frequency:

Corporate boards were often staggered or "classified". For example, in any given year one-third of the directors may be up for election to a three year term. However, many mutual funds have become proponents of annual corporate directors elections. This makes sense of course – if you have an underperforming director, shareholders should not have to wait several years before

having an opportunity to address it. Below are examples of mutual fund policies concerning the election of corporate directors.

Fund Complex	Proxy Voting Policy for Election of Corporate Directors
American Funds	We generally support the annual election of a company's nominees for director... We believe that declassification (the annual election of all directors) increases a board's sense of accountability to shareholders.
Blackrock	We encourage boards to routinely refresh their membership to ensure that new viewpoints are included in the boardroom... We believe that classification of the board dilutes shareholders' right to evaluate promptly a board's performance and limits shareholder selection of their representatives.
Franklin Templeton	Generally vote against management efforts to classify a board and generally support proposals to declassify the board of directors
Goldman Sachs	Generally vote for proposals requesting that the board adopt a declassified structure
Invesco	Invesco supports proposals to elect directors annually instead of electing them to staggered multi-year terms because annual elections increase a board's level of accountability to its shareholders.
JP Morgan	We would generally vote for proposals asking for the board to initiate the appropriate process to amend the company's governance documents (certificate of incorporation or bylaws) to provide that director nominees shall be elected by the affirmative vote of the majority of votes cast at an annual meeting of shareholders.
OppenheimerFunds	Generally vote for precatory and binding resolutions requesting that the board change the company's bylaws to stipulate that directors need to be elected annually with an affirmative majority of votes cast.
MFS	Generally support proposals to declassify a board
TIAA-CREF	Generally support shareholder resolutions asking that each member of the board stand for re-election annually. ...Directors should be elected annually by a majority rather than a plurality of votes cast.

The above policies are all very supportive of shareholder rights. Interestingly, this is generally not how mutual fund directors treat their own board seats. It is not uncommon for a mutual fund board to allow its directors to serve for an indefinite term, or until their resignation, retirement, death or removal. Today such a policy for a public operating company would likely be met with very aggressive efforts by shareholders to amend the corporation's governing documents and/or replace the entire board. Some mutual funds have policies where directors are slated to retire upon reaching a certain age (often in their mid-70's), however they are often subject to waivers by the board or the age limits are raised over time.

The initial board of directors of a mutual fund is typically hand-picked by the investment adviser that the board will be overseeing. Most of these directors will be “independent” insofar as they do not meet the legal definition of being “interested”. This does not mean that there are not pre-existing relationships between executives of the investment adviser and the initial mutual fund board of directors. The Investment Company Act of 1940 requires that at least two-thirds of the board be elected by shareholders. Since the investment adviser is typically the sole shareholder of a newly launched mutual fund it can “elect” all of the initial directors. The board can also add new directors without a shareholder vote until it falls below the two-thirds elected threshold. Thus, while mutual funds now often support annual elections for all portfolio company directors, mutual funds go through great lengths to avoid having shareholder meetings for any reason, including their own director elections.

It is also worth noting that in terms of tenure, there is a growing sentiment that after ten years of board service there is a presumption that a corporate director is no longer independent. A similar approach for mutual fund directors may also be seen as an improvement over the current structure.

Director Compensation

Many mutual funds expect corporate directors of portfolio companies to receive a portion of their compensation in shares of their company. The rationale is that the directors’ compensation should be aligned with those of the company and its shareholders and they should have “skin in the game”. Below are a few examples of mutual fund policies on stock compensation for independent corporate directors.

Fund Complex	Proxy Policies on Equity Compensation for Corporate Directors
American Funds	We generally support equity-based compensation for non-employee directors that aligns their interests with shareholders...
BlackRock	We believe that compensation for independent directors should be structured to align the interests of the directors with those of shareholders, whom the directors have been elected to represent. We believe that independent director compensation packages based on the company’s long-term performance and that include some form of long-term equity compensation are more likely to meet this goal; therefore, we typically support proposals to provide such compensation packages...
Franklin Templeton	Normally support proposals that require that a percentage of directors' compensation be in the form of common stock, as it aligns their interests with those of the shareholders.
JP Morgan	JPMAM believes that non-executive directors should be paid, at least in part, in shares of the company wherever possible, in order to align their interests with the interests of shareholders...Vote for shareholder proposals requiring directors to own a minimum amount of company stock in order to qualify as a director or to remain on the board, so

	long as such minimum amount is not excessive or unreasonable.
OppenheimerFunds	Vote for director compensation plans with director stock ownership guidelines with a minimum of three times the annual cash retainer...
TIAA-CREF	Directors should have a direct, personal and meaningful investment in the common stock of the company. We believe that stock ownership helps align board members' interests with those of shareholders. Director compensation programs should include a balanced mix of cash and equity and be structured to encourage a long-term perspective.

The well-known Morningstar® mutual fund rankings include a Stewardship Grade that evaluates the degree to which the management company's and fund board's interests are aligned with fund shareholders. To this end, Morningstar examines whether at least 75 percent of a board's independent directors have more money invested in the funds they oversee than they receive in aggregate annual compensation for serving on the board.⁵

In yet another contrast, most mutual fund boards do not impose any share ownership requirements for their own directors. Furthermore, most mutual fund directors are not required to receive any portion of their compensation in the form of shares of the mutual funds they oversee.

While too high a percentage of mutual fund share-based compensation for directors could jeopardize the board's prudence and undermine risk oversight, having directors' economic interests aligned with shareholders should be a common sense best practice for both corporate and mutual fund boards.

Director Over-boarding

It was not uncommon to see an individual serving on a large number of corporate boards simultaneously. Given the time commitments and potential conflicts, mutual funds and other investors began to clamp down on this problem as evidenced in the policies below.

Fund Complex	Proxy Policies on Over-boarding for Corporate Directors
BlackRock	Withhold votes... where a director has committed himself or herself to service on a large number of boards, such that we deem it unlikely that the director will be able to commit sufficient focus and time to a particular company (commonly referred to as "over-boarding")...BlackRock is most likely to withhold votes for over-boarding where a director is: 1) serving on more than four public company boards; or 2) is a chief executive officer at a public company and is serving on more than two public company boards in addition to the board of the company where they serve as CEO.

JP Morgan	Withhold from directors who are CEOs of publicly-traded companies who serve on more than three public boards and all other directors who serve on more than four public company boards.
Morgan Stanley	We consider withholding support from or voting against a nominee who appears overcommitted, particularly through service on an excessive number of boards.

The Morningstar Stewardship Grade takes a mutual fund board's workload into consideration as far as the fund complex is concerned. Their analysis includes whether the board is overseeing so many funds that it may compromise the ability to diligently protect the interests of shareholders to a specific fund. Despite the concern of mutual fund boards that corporate directors not be over-boarded, most mutual fund complexes do not have a limitation on the number of boards that their directors serve on. Moreover, some mutual fund complexes have a single board overseeing more than one hundred mutual funds.

Serving as a director on a mutual fund board is not a casual affair as reflected by total compensation that can reach a few hundred thousand dollars per year. As they do for corporate directors, it seems apparent that mutual fund directors should limit the number of public company and investment company boards they serve on to ensure they are not spread too thin.

Attendance Requirements for Directors

Regular attendance at board and committee meetings should be a prerequisite for directors of any organization. To this end, mutual funds boards are holding corporate directors accountable when they do not attend meetings as shown below.

Fund Complex	Proxy Policies on Meeting Attendance for Corporate Directors
BlackRock	Withhold votes where a director has a pattern over a period of years of attending less than 75% of combined board and applicable key committee meetings.
Fidelity	Withhold for directors who attended fewer than 75% of the aggregate number of meetings of the board or its committees on which the director served during the company's prior fiscal year, absent extenuating circumstances.
Goldman Sachs	Vote against nominees who attend less than 75 percent of the board and committee meetings without a disclosed valid excuse for each of the last two years;
JP Morgan	We will not support the re-election of external board members whose attendance at board meetings falls below 75%.
Morgan Stanley	We consider withholding support from or voting against a nominee who has failed to attend at least 75% of the nominee's board and board committee meetings within a given year without a reasonable excuse. We also consider opposing nominees if the company does not meet market standards for disclosure on attendance.

A formal 75% attendance requirement for corporate directors seems fairly reasonable. So what is the industry standard attendance requirement for mutual fund directors? It does not exist. Where mutual funds shareholders do not have the opportunity to vote on directors annually and are unaware of the attendance records of individual fund directors, mutual fund boards may need to adopt attendance policies requiring directors to fully participate or face automatic removal from the board.

In the Absence of Annual Democratic Elections by Shareholders Should There Be Reasonable Director Qualifications?

Before an individual can be employed to sell mutual funds to the public, she/he is required to pass the Financial Industry Regulatory Authority (FINRA) Investment Company/Variable Contracts Products Limited Representative Qualification Examination (Series 6 Exam). The examination has 100 multiple choice questions, requires at least 70% to pass, and costs approximately \$100. There are numerous relevant subject matters such as types of investment risk, suitability, investment company law basics, types of mutual funds, functions of service providers, rights of shareholders, valuation, sales charges and expenses, ethics, etc. These matters are all relevant to fund directors as overreliance on the investment adviser and outside legal counsel is not effective oversight or governance.

While individuals selling mutual funds have an industry requirement to pass a minimum comprehension test, fund directors who make the most critical decisions have no similar requirement. Additionally, most mutual fund complexes do not require directors to complete any particular educational program or continuing education. If a potential mutual fund director was unwilling or unable to take and pass this basic exam, or arguably one more rigorous, the requirement itself would have been successful in weeding out a poor candidate. Additionally, the ability to attract and retain fund directors should not be impacted since these are extremely sought after positions.

Investment advisers, fund shareholders, and industry regulators should support having directors be at least as knowledgeable as fund salespeople. Since many mutual fund directors are very long-tenured, reasonable continuing education requirements may also be justified.

Lack of Accountability Necessitates Better Corporate Governance for Mutual Funds

The actions of public corporate boards are often highly scrutinized by sophisticated financial analysts, mutual funds, pension funds, hedge funds, other institutional investors, proxy voting advisory firms, and the media. Mutual funds and other institutions often hire proxy advisory firms such as Institutional Shareholder Services Inc. or Glass, Lewis & Co. to assist with the formulation of proxy voting guidelines and in the exercise of voting. These guidelines often address director qualifications, tenure, declassified boards, majority voting, compensation, attendance, etc. Additionally, when a corporation releases the slate of director nominees, the

proxy advisory firms will conduct in depth research of each candidate and make recommendations to their clients on which individuals to support.

Proxy advisory firms, like Morningstar and Lipper, derive a material percentage of their revenues from their mutual fund clients; these firms have no incentive to promote accountability on mutual fund boards who could in turn cancel their contracts. Unlike corporations, mutual funds are typically held by individual investors with much lower ownership percentages. Therefore, these individual fund shareholders are not assisted in their fund voting efforts by seasoned governance experts.

Thanks in part to the efforts of mutual funds, corporate directors are now expected to be highly qualified, attend meetings regularly, not be overcommitted to multiple boards, be subject to annual elections, be held accountable for implementing best practices on their committees, and have their interests aligned with shareholders. Because mutual fund boards are not subject to the same level of scrutiny or accountability, it is that much more important that they implement governance best practices. Corporate scandals caused in part by a lack of effective board oversight ultimately led Congress, the SEC, and institutional investors to force change. If meaningful problems were to be found in the mutual fund industry, mutual fund boards could face far more Draconian measures, including more calls for the complete elimination of fund boards.⁶

Lacking both formal governance best practices and accountability to shareholders is not a sustainable position for mutual fund boards. In many cases mutual funds could start by simply taking their own proxy voting policies for portfolio companies and engage in some honest introspection.

As valuable a service as they provide, mutual funds are successful only because the public perceives the industry as honest, credible and professional. But, any public perception that the industry - or even a significant portion of the industry - maintains a lesser standard of integrity could seriously harm the standing of the entire industry. Therefore, it is the mutual funds industry, itself, which has the greatest stake in maintaining its traditionally high standards of integrity.

- Harold Williams, SEC Chairman, Remarks to ICI, May 14, 1980⁷

¹ Any opinions expressed in this paper do not necessarily reflect those of any other person or entity.

² According to the Investment Company Institute.

³ See *A Challenge to Mutual Funds*, Harold M. Williams, May 17, 1978, available from SEC Historical Society at http://3197d6d14b5f19f2f440-5e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1970/1978_0517_Williams_ICIT.pdf.

⁴ See *Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies* available at www.sec.gov/rules/final/33-8188.htm.

⁵ Morningstar Stewardship Grade for Funds available at http://corporate.morningstar.com/us/documents/MethodologyDocuments/FactSheets/MorningstarStwrshpGrade_FactSheet.pdf.

⁶ See, for example, *Competitive Equity: A Better Way to Organize Mutual Funds*, available at www.aei.org/files/2013/12/19/-competitive-equity-book_134822374192.pdf. See also *Taking Exit Rights Seriously*:

Why Governance and Fee Litigation Don't Work in Mutual Funds, available at
www.yalelawjournal.org/images/pdfs/907.pdf.

⁷ See *Some Further Challenges to Mutual Funds*, available from SEC Historical Society at
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