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What Role Is There for Independent Directors of Mutual Funds?

Kenneth E. Scott*

What do mutual fund independent directors do? What can reasonably be expected of them?

I. MONITORING

Independent directors of mutual funds in a typical retail complex are monitors of the management company, which is a separate organization. The directors monitor investment performance, shareholder service and total costs. They also monitor the level of risk created by the management of the portfolio.

Focusing on the management fee is not particularly well-conceived. Directors should be focusing on total cost for total performance. To perform that role, a director needs to be able to do rather objective measurements of performance, both in service and in terms of portfolio. The

*Kenneth E. Scott is the Ralph M. Parsons Professor of Law and Business Emeritus at Stanford Law School. He is also an independent director, American Century Funds and Dresdner RCM Capital Funds. This text is taken from remarks by Professor Scott at the SEC Roundtable on the Role of Independent Investment Company Directors (February 23, 1999).

1 The roles of independent mutual fund directors and of directors of corporations differ in at least three ways. First, there are differences in the legal frameworks that apply and in the structures of the positions, that result in mutual fund independent directors potentially being in a stronger legal position. Second, the mutual fund business is, relatively speaking, a narrower product line than most businesses. I think it is possible for independent directors, either initially or over time, to have a better grasp of the business than is true probably for the directors of a great many large New York Stock Exchange-type companies. The third distinction though cuts the other way. To some degree there are large stockholders of New York Stock Exchange companies who can play significant roles in the corporate governance of those firms, either directly through contact with management or by taking positions in proxy contests or takeover bids. There is no counterpart in the mutual fund world.
issue is the role of the director in pushing to get objective measurements of costs in relation to quality of service and of returns in relation to risk.

There is a lot of attention paid to total returns. The treatment of risk, both in prospectuses and I suspect sometimes internally in the complexes, is much cruder. The challenge lies in devising appropriate benchmarks that include measures for both return and risk, and monitoring the performance of the fund managers with respect to the benchmark and also with respect to adherence to the risk levels that are implied by the benchmark.\(^2\) Bar graphs as a measure of volatility or risk are a very primitive way to go about this.

On objectively measuring costs, it is costs in relation to what? It is in relation to, among other things, the size of the fund and the size of the complex. What some of the boards on which I serve have been doing internally for several decades is following a regression methodology\(^3\) to try to establish a cost benchmark that is sensitive to the particulars of the cost environment and can serve as a basis for evaluating cost performance or setting an expense cap.

II. BARGAINING

The second part of this task, though, is what do you do with the measurements, assuming you have the data (which are usually not difficult to obtain), and have found an appropriate way to measure them. The standard answer is that the independent directors are supposed to use the information derived from their measurements to act on behalf of shareholders when renewing the

\(^2\) Setting a benchmark means choosing some published index or target portfolio, whose returns (and their variance) can be compared to those of the fund.

\(^3\) Regression analysis is a mathematical technique for using industry data to determine the extent to which a dependent variable (for example, fund operating costs) is explained by certain other factors (for example, complex size, fund size, average account size, etc.).
management contract. And here I think there are two concepts of the role of the board that have never really been sorted out or very clearly distinguished.

Are independent directors supposed to be there as a line of defense against management gross overreaching or management failure, a safeguard against the extremes, or are they supposed to be there as arm's-length bargaining representatives on behalf of the shareholders? Those are the polar positions; obviously, there could be intermediate positions along the continuum.

The minimal concept of the role of the independent directors on the board is that they are there to keep the fee "reasonable." They are an outer check on the management company. The greater check, because this is a competitive industry, is in the marketplace. But the independent directors serve as a secondary kind of check. And, therefore, you invoke things like the business judgment rule.

The stronger concept is that the independent directors are there to be independent bargaining agents for the shareholders. It has never been completely clear that is really the Securities and Exchange Commission's view of what the Investment Company Act is all about.

Here you have to distinguish between a standard of conduct and a standard of liability. The standards of personal liability for directors clearly are duty of care, gross negligence, the business judgment rule, that kind of thing. The conduct norm for which the Investment Company Act seems to be striving is that the independent directors are truly independent directors — they are not like interested persons of the adviser making defensible business judgments. That is what the statute appears to

4 Another answer is to increase disclosure of some of the measurements. For more discussion of this option, see Part III, infra.
have in mind. However, there has never really been a consensus in the industry or at the Commission on the matter.

The conclusion I think that some might draw from recent cases like Yacktman and Navellier is that you cannot be an independent director — you may be a disinterested director, but you are not an independent director — if you are subject to removal by the management company. Independence is a question not of the amount of fees or director compensation. Independence is a reflection of how you got on the board and how can you be taken off the board. Who puts you there and who keeps you there? Who can push you off? If the answer to those questions is the management company, then you are not independent of the management company. And if you are not independent of the management company, the notion that you can act effectively in an arm’s-length bargaining capacity, vis-à-vis the management company, is silly.

This is not to say that the outsiders on the board do not in most cases have a certain amount of clout that they can use. I think probably we have all experienced that. The amount of clout independent directors have is a function of institutional factors, such as what the law says is the

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7Section 15(c) of the Investment Company Act requires contracts between an open-end investment company and its investment adviser and principal underwriter to be approved "by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party." 15 U.S.C. § 80a-15(c) (1999). Section 2(a)(19)(B) of the Act lists those categories of persons who are considered to be interested persons of an investment adviser or principal underwriter. 15 U.S.C. § 80a-2(a)(19)(B) (1999).

8The Yacktman and Navellier situations involved clashes between independent directors and fund investment advisers. In both situations independent directors who questioned how the investment adviser was operating a mutual fund were successfully ousted by management. See David A. Sturms, Enhancing the Effectiveness of Independent Directors: Is the System Broken, Creaking or Working?, 1 VILL. J.L. & INV. MGMT. 103, 109-111 (1999).

9The focus on director compensation is a kind of misdirection. It fascinates Barrons and the Wall Street Journal. I don’t think it should be the focus of people who think seriously about these matters.
percentage of outside directors or the process by which vacancies are filled.10

At the outset in a new complex and a new fund obviously the directors are chosen by management. There should be no illusions about that. But then if they are, indeed, of a mind to be independent, or independence develops over time, that tie to the initial source of appointment becomes attenuated. People change, management turns over, directors turn over, new people come in. I think as a sociological matter (not that I know a study has ever been done) you would expect to see that over time there would be a growing degree of independence — and, after all, it is a matter of degree and not all or nothing.

If the individual board members have an attitude of independence, how far can they push it? Navellier and Yacktman suggest that there are limits as to how far they can push it. But note that those limits, nonetheless, give independent directors quite a bit of potential bargaining power, because in both cases although the independent directors lost,11 the fight was costly to the funds.12 They shrank enormously in assets.13 So, again, independent

10 The Securities and Exchange Commission has recently proposed “a number of rule and form changes to enhance the independence and effectiveness of fund boards of directors” with a particular emphasis on the role of independent directors. Among the proposed changes are proposals to require the following: (i) that, under ordinary circumstances, either a majority or a super-majority of a fund’s board of directors be independent; (ii) that, to the extent permitted by state law, independent directors nominate and select new independent directors; and (iii) that, if the board has counsel, the counsel be independent of management. Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,082, at *5 (Oct. 14, 1999), 64 Fed. Reg. 59,826, at 59,829 (Nov. 3, 1999).

11 It was not too surprising that independent directors lost. The shareholders knew the name on the fund, not the names of the independent directors.

12 Of course, the fight was also costly to the independent directors or defendants in the lawsuits.

13 According to a Post-Effective Prospectus Amendment filed by the Navellier Aggressive Small Cap Equity Portfolio on May 1, 1998, its assets declined from approximately $190 million at the end of 1996 to $73 million at the end of 1997. 485BPOS filed by the Navellier Aggressive Small Cap Equity Portfolio (CIK 906518) on May 1, 1998.
directors have to make nuanced judgments about the degree of their clout and decide which situations warrant trying to actually make use of it. But is there some bargaining power if the directors are sufficiently independent in attitude that they want to use it? You know, of course, there is.

III. FOSTERING COMPETITION

If you assume a competitive market, then what is the role of the independent director? I think it is quite a limited role. But first, how competitive is the market and what are the limits of competition? Then, what can or should independent directors do to encourage competition and informed choice?

A competitive market works through customers switching. If I switch from one brand of peanut butter to another brand of peanut butter, I do not have a very high switching cost. The transaction cost is pretty low. Even if I am switching from one automobile to another automobile, my investment in the automobile I have is running down over time. I can probably make a relatively low cost transition, as I get to the point where I want to buy a new car anyway.

What is the measure of transaction cost in switching in the mutual fund industry, in this kind of product? It is not almost zero, as it is with the peanut butter. The transition cost is partly an information cost and that gets us into the realm of disclosure. It is partly, because of the way the market has performed in the last half-dozen to a dozen years, the cost of realizing all of the deferred capital gains and incurring the taxes that a shareholder could trigger by deciding to switch. Is that a full lock-in? No. Is it in some instances a significant transition transaction cost? Yes.

With peanut butter as with most products, what I am buying, what the price tag tells me I am going to get, is already there. It is in the jar. When you buy a mutual fund, you are not buying something in the jar. You are buying some future expectations. You are buying future performance. That means that determining comparability is far, far more difficult than when we are talking about peanut butter or automobiles. It is within the margin of the transaction cost in switching, it seems to me, that you are exploring whether or not the independent director can make a difference in terms of the factors that bear on your decision to switch.

What can be done to assist people in making a decision about switching and to assist people in general in knowing what they are buying when they buy a mutual fund? The data we get in the prospectus are all historical data, backward looking. They answer the question: what did the fund do in stated past periods? To the extent that the past is a good predictor of the future which, of course, every prospectus denies, and which every investor disregards, it does have some value.

But what do you do internally within a complex in looking at the performance of your portfolio managers? You generally do not reward them on the basis of what they did two or three years ago. In the complex with which I am most familiar, what the independent directors look at are the benchmarks that they have established for the manager and how the manager performs with respect to those benchmarks in the time periods to come. If that is what makes sense for the management company and independent directors — how is the portfolio manager doing vis-à-vis his bogey — would you not think that would be the kind of information that would be even more relevant to investors than how this manager or some other manager did in times past with respect to this or some other benchmark or bogey? I would think that forward-looking disclosure would actually be of greater investor value.
This is not to suggest that the prospectus should predict how the fund will do the next year. That is beyond us all. All I am saying is that internally we look at, and externally I presume one could disclose, an existing fact. What is the benchmark in relation to which this manager is trying to manage this fund? The benchmark or the strategy may change in the future, if there is a decision to do so, but disclosure of the current benchmark is disclosure of a fact.

IV. CONCLUSION

What do the independent directors of mutual funds do? They set goals for management. They monitor the performance of management vis-à-vis those goals. They act at least as an outer check on management. What else could they do? They could disclose the benchmarks that they use to evaluate management. Such disclosure might also enhance the competitiveness of the market, indirectly promoting a more effective check on management than the independent directors alone can otherwise provide.