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IDC: Independence rule unnecessary for boards

By David Hoffman
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Fund boards have adopted governance practices that are thought to serve the best interests of shareholders "in advance, or in the absence, of any regulatory mandate to do so," according to a new study from Independent Directors Council. The group is part of the Washington-based Investment Company Institute, the mutual fund industry's main trade group.

Technically, the industry's self-congratulation over voluntary adoption of governance "best practices" is well founded, said industry watchers. But it's doubtful that fund boards would have become more independent minded without prodding from the Securities and Exchange Commission, said Niels Holch, executive director of the Coalition of Mutual Fund Investors in Washington.

The IDC said that between 2000 and 2006, the number of fund complexes reporting that independent directors held 75% or more of board seats rose to 88%, from 52%.

In addition, 56% of complexes reported having boards with independent chairmen at yearend 2006, they said.

That means that when complexes that had boards with independent lead directors also were considered, 78% of participating complexes reported having an independent director in board leadership at the end of last year, up from 22% in 1996, according to an IDC report released this month.

While no rule requires independent directors to hold 75% or more of board seats, or boards to have independent chairmen, that situation exists only because a federal appeals court invalidated requirements in a 2004 SEC rule that called for such measures.

The rule, however, isn't completely dead.

The court ruled it invalid because, it said, the SEC failed to research fully its potential impact. As a result, the commission is debating the rule's pros and cons.

The council, however, views the results of its study as evidence that such a rule isn't needed. "What [regulators] should take away is, the market has responded loud and clear," said Amy Lancellotta, managing director at the council.

The threat that investors would yank dollars out of funds caught up in the market-timing and late-trading scandals generated more than enough pressure on those fund boards that hadn't already re-examined governance practices to do so, she said.

For example, the vast majority (94%) of fund complexes at the end of 2006 had a financial expert serving on an audit committee — a best practice suggested by the council — though they were not required to do so, according to the report.

Many boards responded to the trading scandals by requiring fund boards to appoint an independent chairman, but those that didn't appoint them shouldn't be penalized, Ms. Lancellotta said.

"I don't think there is a direct correlation between an independent lead director, or an independent chair, and a fund that violates a rule," she said.

That may be true, but having an independent chairman is a "strong statement" that a board has its shareholders' best interests at heart, Mr. Holch said.

And the idea that fund shareholders can take their money out of a fund that doesn't have their best interests at heart is a fallacy, said C. Meyrick

Payne, a senior partner at Management Practice Inc., a Stamford, Conn., a consulting firm for independent fund directors.

Investors face redemption fees and tax penalties for leaving, Mr. Payne said.

As a result, the market for mutual funds is anything but free, he said.

Groups such as the council, however, are trying to twist the data to suggest that independent directors and chairman aren't necessary — or at the very least, that a rule requiring them isn't necessary, Mr. Payne said.

It's all part of an attempt to make independent directors "less powerful," he said.

That's not the case, Ms. Lancellotta said.

The group supports the notion that independent directors hold 75% or more of board seats, she said.

It just doesn't believe that an independent chairman is necessary to safeguard shareholder interests, Ms. Lancellotta said.

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Amy Lancellotta: Independent chairman may not protect investors.

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