



## Changing Drivers? The Leadership of Mutual Fund Boards and Recently Amended SEC Requirements

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### Overview

Pick up the annual report of your favorite mutual fund and check out the person who is currently sitting in the driver's seat as Chairman of the Board. If that person is associated with the fund's management, they will be moving to a passenger's seat very soon.

On June 23, 2004, the SEC announced important amendments to the rules governing the leadership and composition of mutual fund boards. The SEC was spurred to action by recent scandals related to after-hours trading and inadequate disclosure by mutual fund companies. Post-Enron, both investors and regulators were quick to press for more vigorous fiduciary oversight by fund boards.

What is the essence of the SEC rule changes? First, the new rules require that 75% of the seats on a mutual fund board be reserved for independent ("non-interested") members. Second, and more controversial, the SEC called for a change of drivers—mutual funds must appoint an independent Chairman of the Board.

According to SEC Commissioner Paul Atkins, "...nearly 2,000 funds do not currently meet the first criterion, and 80% of all funds do not have a non-executive chairman."<sup>1</sup> We believe that this will mean that Retirement Plan Sponsors should prepare for an unusually active proxy season, and for casting important votes on board leadership and governance.

### The New Rules

**Will the funds in which you invest be required to change board leadership? What are the practical implications of these changes?**

The SEC made the following five amendments to the rules concerning Investment Company Governance.

1. Independent Composition: Independent directors must constitute at least 75% of the fund's board. An exception allows fund boards with three members to hold a 2/3 (66.6%) ratio.
2. Independent Chairman: The board will be required to appoint a chairman who is an independent director.
3. Self-Assessment: The board will be required to assess its own effectiveness at least once a year, including review of committee structure and number of funds on whose boards the members serve.
4. Separate Meetings of Directors: The independent directors are required to meet in separate sessions at least once a quarter.
5. Independent Director Staff: The fund will be required to authorize the independent directors to hire their own staff.

(SEC Press Release 2004-87, dated 7/23/04)



Compliance with these five new requirements will be required 18 months after their publication in the Federal Register (sometime early 2006). The new procedural requirements (3-5 above) seem designed to discourage window dressing, and to foster more vigorous oversight by independent directors.

## The Impact

To gain some sense of the impact of these rule changes, we examined the board composition and leadership of the five largest equity funds as of July 20, 2004:

- ❖ Fidelity Magellan
- ❖ Investment Company of America (American Funds)
- ❖ Washington Mutual Investors (American Funds)
- ❖ Vanguard Windsor
- ❖ Income Fund of America (American Funds)

We will summarize the results here, but for more detail see the “Nuts and Bolts” section that follows this report. We compared the current composition and leadership of these major mutual funds to the new SEC requirements.

### Are Boards currently Independent? (Board Composition Requirement)

❖ Vanguard Windsor	85.7
❖ Income Fund of America	80.0
❖ Fidelity Magellan	69.2
❖ Investment Company of America	66.7
❖ Washington Mutual Investors	69.2

### Is the Current Board Chairman Independent? (Board Leadership Requirement)

❖ Fidelity Magellan	NO
❖ Investment Company of America	NO
❖ Washington Mutual Investor	NO
❖ Vanguard Windsor	NO
❖ Income Fund of America	NO

In summary, **only two** of the five largest equity fund boards (Vanguard Windsor, Income Fund of America) currently meet the new SEC Composition requirement. **None** of the five largest equity funds currently meet the Independent Leadership requirement.

While a slim minority of funds may currently meet both the Composition and Leadership rules for board independence, most funds will need to change board composition and/or leadership in some significant ways over the next 18 months. And many major funds, such as the ones we examined here, will ALL be selecting new Independent Chairmen by early 2006.

## Monitoring the Changes

The next several months promise to be a time of unprecedented flux on mutual fund boards. We see three key areas that require monitoring and evaluation.

1. Drivers Wanted: The selection of so many independent directors in such a short time frame may create keen competition for ideal candidates. It seems likely that many funds will select those independent members with longer tenure. But following such a strategy may limit the fund to a small number of members, each of whom is more likely than junior members to hold multiple board memberships. Certainly a fund could take the alternative approach of selecting a junior/new board member. While this move would clearly be in step with the SEC notion of



independence, shareholders might be concerned about the risks associated with such a dramatic change in leadership.

2. Battles over Independence: Over the past several years the SEC and other institutions have worked to refine the definition of *independence*. The new SEC rules are crystal clear on the percentage of independent members and on the notion of an independent chairman of the board. But these “sharp lines” are likely to shift the battleground from meeting the composition and leadership requirements, to the *classification criteria* for independence. Investors should carefully evaluate the degree to which funds appropriately classify directors as independent. Also, while *formal* leadership will be transferred to independent directors, fund officers will likely continue to exert strong influence over board decisions. The SEC announced *procedural requirements* (e.g., separate meetings of independent directors) along with the formal leadership requirement, and we see this move as a signal that investors should also continue to carefully monitor *board procedures and decision making*. Requiring formal independence by no means “solves” potential conflicts of interest on fund boards.
3. An Active Proxy Season: Proxy activity will increase sharply over the next few years. At a minimum, the proxy agenda will need to expand to meet the new SEC governance requirements. Boards that are under the 75% independence criterion will need to add new outside directors. The overwhelming majority of funds will need to elect a new independent Board Chairman. In addition to these governance issues, however, the next few seasons of proxy voting are likely to include important contests regarding transparency and appropriate disclosure, relationships between funds and their advisors, and the composition and reporting of fees.

The recently amended SEC rules for mutual fund governance require significant changes in both board composition and process. In sum, we think that these changes are positive and likely to encourage healthier governance. But we also believe that the approaches, which funds use to meet these requirements, are likely to vary considerably. Although the upcoming proxy season promises to be hectic, careful shareholder evaluation and voting may prove critical to the success or failure of mutual fund reform.

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<sup>1</sup> As quoted in “SEC Commissioner critiques investment company governance rules,” *Securities Week*, vol. 31, number 26 (June 2-8, 2004), p. 7.



## Nuts & Bolts

### Details of Board Composition Analysis and Mutual Fund Board Composition Analysis of the Five Largest Equity Funds

## EXHIBIT A

**Rank #1: Fidelity Magellan**

Interested Members	Year Appointed	Age	Current Board Composition Analysis	
			Count	Percentage
<b>Edward C. Johnson, III</b>	<b>1984</b>	73	3	23.1%
Abigail P. Johnson	2001	42		
Laura P. Cronin	2003	49		
<b>Non-Interested Board</b>				
J. Michael Cook	2001	61	10	76.9%
Ralph F. Cox	1991	71		
Robert M. Gates	1997	60		
George H. Helmeier	2004	67		
Donald J. Kirk	1987	71		
Marie J. Knowles	2001	57		
Ned C. Lautenbach	2000	60		
Marvin L. Mann	1993	70		
William O. McCoy	1997	70		
William S. Stavropoulos	2001	64		

## EXHIBIT B

**Rank: #2: Investment Company of America (American Funds)**

Interested Members	Year Appointed	Age	Current Board Composition Analysis	
			Count	Percentage
<b>R. Michael Shanahan</b>	<b>1994</b>	<b>55</b>	5	33.30%
Paul G. Haaga, Jr.	2002	55		
James B. Lovelace	1994	47		
Donald D. O'Neal	1994	43		
James E. Rothenberg	2000	57		
<b>Non-Interested Board:</b>				
Louse H. Bryson	1999	59	10	66.7%
Mary Anne Dolan	2000	56		
Martin Fenton	2000	68		
Leonard R. Fuller	2002	57		
Claudio X. Gonzalez	2001	69		
John G. McDonald	1976	66		
Bailey Morris-Eck	1993	59		
Richard G. Newman	1996	69		
Olin C. Robinson	1987	67		
William J. Spencer	1997	73		



EXHIBIT C

**Rank: #3: Washington Mutual Investors (American Funds)**

Interested Members	Year Appointed	Age	Current Board Composition Analysis	
			Count	Percentage
<b>James H. Lemon</b>	<b>1971</b>	<b>67</b>	4	30.80%
Fred J. Brinkman	1997	74		
Harry J. Lister	1972	67		
Jeffrey L. Steele	2000	57		
<b>Non-Interested Board:</b>				
Cyrus A. Ansary	1983	69	9	69.20%
Charles A. Bowsher	2001	72		
Daniel J. Callahan	1997	71		
Edward W. Kelley	2002	71		
James C. Miller, III	1992	60		
Katherine D. Ortega	2002	68		
John Knox Singleton	2001	54		
T. Eugene Smith	1987	72		
Leonard P. Stuart	1997	68		

EXHIBIT D

**Rank: #4: Vanguard Windsor**

Interested Members	Year Appointed	Age	Current Board Composition Analysis	
			Count	Percentage
<b>John J. Brennan</b>	<b>1987</b>	<b>50</b>	1	14.30%
<b>Non-Interested Board:</b>				
Charles D. Ellis	2001	67	6	85.70%
Rajiv L. Gupta	2001	59		
JoAnn Heffernan Heisen	1998	54		
Burton G. Malkiel	1977	72		
Alfred M. Rankin, Jr.	1993	63		
J. Lawrence Wilson	1985	68		

EXHIBIT E

**Rank: #5: The Income Fund of America (American Funds)**

Interested Members	Year Appointed	Age	Current Board Composition Analysis	
			Count	Percentage
<b>Janet P. McKinley</b>	<b>1994</b>	<b>48</b>	2	20.00%
Darcy P. Kopcho	1997	49		
<b>Non-Interested Board:</b>				
Robert A. Fox	1972	66	8	80.00%
Leonade D. Jones	1993	55		
John M. Lillie	2003	66		
John G. McDonald	1976	66		
Luis G. Nogales	2002	59		
James K. Peterson	1999	62		
Henry E. Riggs	1989	68		
Patricia K. Woolf	1985	69		

Notes: 1) Chairman of each Board appears in bold. 2) Rank: Asset Size among Equity Funds - Securities offered through Securities Service Network, Inc. - Member NASD/SIPC - © Copyright 2004 Pension Consultants, Inc. All Rights Reserved.

