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Mutual Fund Board Culture

Building an Effective Group of "Watchdogs"

This topical white paper is one in a series and is designed to examine topics of interest to mutual fund Boards and their business colleagues. It is intended primarily for ***Keil Fiduciary Strategies LLC*** *(KFS) clients and their legal counsel's informational use. Yet, other investment company business participants are also free to download and print this document – from www.keilfiduciarystrategies.com – on a fully gratis basis. Readers need be aware that the terminology employed in this paper assumes a certain level of knowledge of the funds business. KFS retains all ownership, rights and privileges of this document's intellectual content, to the extent not previously published.*

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PREFACE

I hold a justified amount of admiration for the accomplished professionals who serve as fiduciaries of investment companies and thus, "watchdogs" on behalf of fund shareholders. The role they fill presents many challenges, requires a widely diversified skill set, and the list of responsibilities and potential liabilities continues to swell. Fund Trustees must arguably be financially savvy, have background in forensic accounting, intimately understand the spirit and laws of the '40 Act, possess highly refined interpersonal skills, and have enviable business acumen. They must be confident, outspoken, and knowledgeable.

Despite the intelligence, social stature, and best intentions of Trustees, Board "culture" can run awry and in direct contradiction to the main objective: protecting and representing shareholders. Trustees' main focus should be that of relentless, but top-level, shareholder protection and not seek to venture into an Advisor's corporate operations to any great depth. Yet, reconciling contrasting personalities, viewpoints, backgrounds, knowledge bases, biases, and idiosyncracies is no easy task. Regardless of what traits and skills each Trustee brings to the boardroom table, at the end of the day we're all simply human. Therein lies the challenge. In my view, the key is to design an iron-clad structure, and consistent mutually agreed-upon "methods of working" to alleviate the potential for an ambiguous course.

I examine the issue that some Boards have the *potential* to sometimes be non-functioning or somehow dysfunctional in minute and unintentional ways. This premise does not indicate that I feel most groups of Trustees are not highly functioning. Quite the contrary. With very few minor exceptions, I have had the pleasure of working with many competent Trustees and have happily witnessed highly efficient, knowledgeable, well-advised, and engaged Boards. Yet, with a "there's always room for improvement," and "human nature will always creep in, not necessarily for the better" perspectives, I move forward with my analysis of this topic.

INTRODUCTION

I have personally witnessed many dozens of mutual fund complex's Board meetings across the country over the last 25 years. It is fair to say that, while there are commonalities, each fund Board can possess its own unique structure, dynamic, and personality, if you will. One might rightfully postulate that this is due to Board culture which has been created through the 'force' of reigning personalities, by historic influences, possibly through heavy advisor influence, or by Trustee design. Proactive design seems like the best option.

Mutual fund boardrooms across the US are typically filled with very accomplished, highly educated, knowledgeable, confident, mostly retired, strong-willed professionals applying their business judgement and expertise on behalf of shareholders and as their advocates. One could certainly argue that such human capital assembled in the same room would be an extremely powerful tool and be very beneficial for shareholders. Yet, one might also argue that a large group of affluent persons all with such traits might precipitate Board meetings with vigorous arguments, too many sides to a given story, clashing of egos, and perhaps even occasional stalemates and inaction. Clearly, in order to uphold any fiduciary standard, orderly actions must be undertaken and in good faith.

The professional atmosphere inside mutual fund boardrooms, the methods by which decisions are made, and Trustee interaction dynamics – referred to as "Board 'culture" in this paper – is a topic not addressed by most observers of the investment company business. Clearly, culture can vary dramatically, philosophies on effective methods of working may diverge, and personalities can drive how agendas get addressed. Questions such as the following arise when pondering culture and that arguably drive culture. What criteria are used to recruit boardmembers? What time commitment can Trustees make? Is there an independent Chairperson or lead Independent Trustee? Who sets meeting agendas? How are intra-Board disagreements resolved? What are the Board's core principles or unspoken credos by which the Board operates? Can Boards say that they always make appropriate and effective decisions when the need arises? How is the Board self-assessment process conducted?

I seek to explore Board culture (or just "culture") in significant depth and put this potentially contentious topic on the table for the purpose of offering some ideas that Boards should entertain for supporting and/or increasing their efficiency, cohesiveness, and effectiveness. I hope that all Directors/Trustees and all other readers take away some tidbits from my musings which will strengthen their Board's oversight and shareholder advocacy. Obviously, I don't profess to have all the answers and the 'correct' avenue can vary by Board.

Perhaps the not-so-obvious question for Boards of Trustees/Directors is: Does culture just naturally occur through relationships, personalities, and advisor 'guidance' or can it be created, monitored, and shepherded? KFS would argue that proactively molding culture is feasible and should be attempted by all Boards with the intent of a higher level of Board governance. KFS seeks to address these questions, offer suggestions, and spur Trustees in the funds business to shine a bright light on the (perhaps unspoken) processes used by their own Boards, critically examining how culture could be improved.

As vital as it is, this topic has not garnered much limelight recently and many of the principles put forth certainly apply to corporate, foundation and non-profit Boards alike. I hope to change the general level of all Boards and related participants' focus on culture going forward.

* * * * *

Several of the viewpoints and insights reflected in this paper benefited from in-depth conversations with, and feedback from, members of the fund Trustee, Board advocacy, audit, legal, and consulting communities.

I would like to express my sincere appreciation for the time invested in my work by these business participants, their insightful comments, and useful viewpoints. This paper was clearly enhanced by their involvement.

Thank you.

EXECUTIVE SUMMARY

Fund Trustees/Directors and other readers are urged to take away and/or seriously consider the following very macro concepts, core points contemplated by this white paper, and recommendations put forth by Keil Fiduciary Strategies:

- A healthy, productive Board culture can encouraged, fostered, and perpetuated through conscious policy design, structure, and targeted Trustee selection
- Carefully designed Board and Committee charters are key to appropriate focus, time investment, and thus culture
- Trustees should comprehensively understand the core operating principles and behaviors embraced by, and adhered to, by all members of a Board
- An Independent Chairperson or Lead Independent Trustee should be strongly considered
- A Board's core culture should be one which embodies the term fiduciary, does not ever lose sight of shareholder protection, highly values professionalism, and is relentlessly indicative of shareholder advocacy
- High priority should be placed on Trustee education
- "Methods of working" that promote the retention of an acute and undiminished shareholder interest focus should be assembled
- Executive sessions should occur regularly and resulting concerns raised, if any
- Wide diversity in levels and areas of fund expertise, background, educational credentials, skill sets, talents, and general perspectives should be sought
- A strong, confident Chairperson willing to direct meetings, ensure appropriate focus, and surface the 'tough issues', as needed, is key
- A highly qualified, skilled, and forthright counsel should be enlisted and used regularly to clarify responsibilities, outline rules and regulations, craft meeting minutes, and answer vital questions
- A respectful, professional, and candid relationship between the Board and an Advisor's Executive personnel is highly desirable
- A Board should generally be trustful of their funds' Advisor, yet verification of data, materials, and claims may be regularly warranted for the sake of all parties' interests
- Questions of the Advisor by Trustees should be routine and clarifying
- A Board self-assessment is not only a required mechanism, but a useful tool to identify areas of improvement, uncover closely held views, and root out underperformance, if any
- A Board's job is oversight, not management or operational design; a culture which promotes being a "watchdog" and not an extension of an Advisor's operating personnel should be encouraged

CORE OPERATING PRINCIPLES

It is fair to say that any governing entity can benefit from a clear mission and core operating principles. Thus, each fund Board likely has, formally or otherwise, created a charter at one time or another, perhaps during the infancy of the fund complex. Obviously, Boards' goals and responsibilities are deeply ensconced in Rules and Regulations set down by the Investment Company Act of 1940 ('40 Act) and the Securities and Exchange Commission (SEC). Yet, how about more subtle ways in which a Board operates, e.g., Trustee opinions expressed, preferred venues, Board meeting decorum, timing of certain discussions, generally raises issues of concern, determines consensus, etc.? **Charters are arguably central to Board focus and oversight**, but they can be broad and not necessarily clearly directional under all circumstances.

For those previously in Executive corporate positions prior to accepting a Board seat, these issues may be viewed as voluntary, inconsequential, or occur in the matter of course, but they may influence culture and benefit from design or oral reinforcement. For instance, consider the following **ways in which Boards might *actively design* methods of working**, e.g., how meetings are conducted, where authority lies, issues unfold, conflicts are resolved etc.

- Who designs meeting agendas? Is subject matter always the result of Trustee suggestions, actively solicited? Does the keeper of the agendas have the power to accept or jettison items? Is each Trustee expected to raise issues regularly and at a majority of meetings?

- During Trustee discussions, are personal views expected of all Boardmembers? If some Trustees opt to not express their views, routinely or otherwise, is their participation actively solicited? What roles does the Chairperson play, designed intentionally or otherwise?

- Are closed-door sessions of only the independent Trustees regularly scheduled and embraced as a way to promote candid opinions and healthy Board culture?

- Are Trustees' electronic devices in "On" mode and audible during Board meetings? Are Trustees expected to conduct other business outside of meeting times?

- How are discussion stalemates or clearly divided opinions resolved? Is the issue tabled for a future or additional meeting or are meeting times extended to allow for a deeper discussion and resolution?

- Do time allotments for many items seem insufficient? Are meetings' agendas sometimes hurriedly addressed? Is there time for meaningful discussions? Should the Board entertain meeting more frequently, but with a less full agenda? Is this realistic?

- Is the consideration "what does the average shareholder want and expect" appropriately introduced into every applicable discussion? How might the watchdog mandate be reinforced such that owner focus is undiminished and acute?

- If certain ways in which the advisor's operations are conducted are unsettling and/or not embraced by one or more Trustees, how is this concern surfaced as a concern? At what stage or what catalysts might prompt a Board-mandated advisor presentation on the area(s) of concern?

- What is the expected decorum of all Trustees during regular Board meetings, e.g., attire, addressing the Board only when prompted by the Chairperson, occasionally conducting other non-Trustee activities mid-meeting etc.?

- What repercussions should there be if a standing Trustee is accused and/or convicted of a crime? Does the severity matter?

- Are prolonged "side discussions" or cellphone conversations ever allowed to occur during Board meetings? Under what conditions might they be acceptable?

Many seasoned Trustees may feel answers to these questions are instinctively obvious. Yes, widely accepted professional behaviors generally prevail. Yet, the potential for those entering the Trustee ranks who are unclear on the 'blessed decorum' and overall expectations exists. There is very little downside to personally ensuring – with all due respect – that all members of a Board understand the standard operating procedures embraced and adhered to by the group. Make them clear to elevate efficiency and support intra-Board relations.

So, what might be some **"core operating principles" by which a Board may conduct its business** and practice unwavering shareholder advocacy? Consider the following (in no purposeful order):

- ➢ Elect an independent Chairperson or designate a Lead Independent Trustee to direct meetings (or Executive sessions) and design agendas, as needed
- ➢ Trustees are encouraged and expected to submit topics for discussion to the Chairperson
- ➢ Attendance at all Board and Committee meetings is expected in person and at a high level of frequency
- ➢ Set a highly suggested, but not necessarily mandatory, retirement age
- ➢ Form several Board committees guided by detailed charters; each Trustee must participate on at least one Committee
- ➢ A combination of fund experts strong non-experts will deepen and encourage discussions
- ➢ Trustees are expected to join <u>all</u> discussions and provide their viewpoint; if not offered, opinions will be actively solicited
- ➢ A high value is placed on Trustee education and fund business knowledge – regular attendance at training is required
- ➢ New Trustee searches will explicitly by driven by the goal to increase areas of expertise and experience, diversity of perspectives, a mixture of talents, fund business knowledge, and sufficient time availability
- ➢ Regular gatherings (social or otherwise) will occur amongst the Board and the Executives of the advisor to exchange views and create/foster productive relationships
- ➢ All independent Trustees will meeting regularly in "Executive sessions" to provide an atmosphere that promotes frank conversations

- A board self-assessment process which includes independent administration, Trustee submission of questions, public dissemination of the results, and a focus on aggregate Board performance
- The Board will have no less than 75% independent members at any point in time
- The Board Chairperson or Committee Chair will act as liaison and raise concerns with the advisor
- The Trustees will jointly design a process by which discussions ending in divided opinions are resolved such that the Board may move forward
- All Trustees are required, or at the very least strongly encouraged, to have personal assets invested in the funds which they oversee as fiduciaries
- Formal meetings are routinely conducted without distraction by any electronic devices
- Advisory personnel will be asked to regularly present to the Board on a variety of operational issues including staffing, corporate vision(s), compliance, disaster recovery and related
- Portfolio managers will be asked to regularly present to the Board on their performance results, views on the market, and new asset management strategies forthcoming
- Underperforming portfolio managers (for example, 4th or worse quintile for at least 8 quarters) are expected to present to the full Board or a Performance Committee to explain in detail why their results lagged and what shareholders may expect henceforth

[Note: this list is not intended to be inclusive of all possible principles.]

An operating roadmap containing some or all of the aforementioned principles is useful to actively create or foster a targeted Board culture. Conscious decisions about Board structures and operating principles can certainly promote certain behaviors while discouraging others. That which supports independent, candid, meaningful, shareholder-focused discussions and decisions should be embraced.

DIRECTOR QUALIFICATIONS, TRAITS

Arguably the first step in building an effective fund Board is outlining what qualifications candidates must possess and determining the personal traits that are useful to ensure diversified viewpoints and efficient operation. Disclosure requirements currently require that Boards report why current Trustees were selected for service, but not minimum qualifications or baseline attributes by which candidates may have made the ‘cut’ for consideration. Disclosures vary widely and are sometimes viewed as very broad for flexibility, bare bones, or precluding some candidates to build and retain a group of Trustees with similar backgrounds and a bit more homogeneity. Based on disclosures, it appears that not all views on how a Board should be assembled closely align. Furthermore, not all Boards have formal Nominating Committees with detailed charters.

I submit the following qualifications and attributes as vital to thinning down lists of possible Trustee candidates.

Desired Academic Qualifications and/or Knowledge

- A higher-level education commensurate with the expectations of the Trustee role
- Professional experience sufficient to have created a basis for solid judgment
- A high level of general business acumen
- Personal experience in, and/or expertise regarding, the funds business or extensive training, as required
- Knowledge of certain funds' sectors (if applicable)
- General understanding of financial statements
- Holds or maintains no business or highly personal relationships that would compromise ability to be a "watchdog" and/or compromise independence
- Expertise or specific skills current lacking within the Board

Personal Attributes

- An unwavering commitment to representing shareholders' interests
- Desire to fully understand the job's technical aspects and the value of on-going training
- Willingness and ability to devote significant time to the role of Trustee
- Honesty, demonstrated ethical behaviors, general integrity
- A full appreciation for conflicts of interest in business and skill in recognizing sensitive areas
- Understands that implicit trust amongst the applicable circles may be built through verification and over time, yet likely can benefit from regular 'fortification'
- Will express carefully conceived viewpoints regularly and constructively
- Has no trepidation regarding reconciling strongly divergent perspectives
- Can effectively build and maintain professional relationships

BOARD CHAIRPERSON DUTIES, PERSPECTIVES

Given the pivotal role of the individual likely leading the meeting agendas and the Trustee discussions, this key person's personal attributes can not only impact Board decisions, but clearly drive culture. A myriad of personal skills are clearly desired to direct, guide, and spur meaningful Board discussions is pivotal to effective Board function. Perhaps most important, the entire Board should be clear on the role(s) and responsibilities borne by the Chairperson (or simply "the Chair").

For instance, the Board chair should shoulder or coordinate several, if not most, of the following duties: 1) oversees the assembly of each and every full Board meeting's agenda; 2) reaches out to Trustees to build agenda items; 3) facilitates and manages discussions amongst the Trustees; 4) ensures a high level of consensus and that resolutions to problems are attained; 5) encourages participation from all Board members; 6) effectively leverages each Trustees' area(s) of expertise; 7) keeps the Board "on task" in meetings such that all agenda items are addressed (as feasible); 8) calls for Executive sessions where appropriate; 9) follows up with counsel on Board meeting minutes and their specific content; 10) is the primary liaison with management and personally assumes responsibility for having conversations regarding Board concerns over any managerial aspect of the funds being overseen; 11) has personal conversations with Trustees who could reasonably be considered "underperforming" and may have been cited in a Board self-evaluation; 12) responds to Board information requests; 13) monitors the calendar of regulatory events; and 14) manages the Board self-assessment process.

Readers should understand that the above list in not necessarily exhaustive and, under certain Board structures, certain duties may be assumed by Board committees, rather than the Chair.

Focusing on personal skills and to supplement the aforementioned, an effective Board Chairperson should, at the very least, possess the following attributes. The chair should be able to build and command respect from fellow Trustees. He/she should clearly be extremely articulate. Being able to create and support a culture of collegiality, ethical behavior, teamwork and trust surely supports a healthy culture. They should be able to skillfully interact with advisory personnel to address and rectify concerns while maintaining productive relationships and healthy rapport. Furthermore, without the desire and affinity to track and understand current fund business issues, they would be much less effective. Ineffectiveness would also be exacerbated by the lack of confidence, directness, a commanding presence and a "strong personality" – they must not be timid about surfacing the tough issues. He/she should have the ability to manage debates on vital issues and steer them towards reasonable conclusions and/or compromises, as needed. Given the nature of today's litigious atmosphere and large fund complexes as targets, being "deposable" (can answer tough litigator questions under duress) is clearly a plus. Readers may rightfully consider this a stringent list that only a few, select individuals measure up to. I would concur.

Moving to what I will refer to as "productive perspectives," a Chair must support the notion that intra-Board and Board/Advisor collaboration is vital to a Board's success. They must possesses a healthy (not destructive) amount of skepticism when provided with Board materials, yet trust that advisory personnel's interests generally align with Board goals. He/she must support on-going education for all Trustees and fully appreciate the value of contrasting opinions and perspectives. The Chair should understand the criticality of shareholder advocacy, but appreciates the need for balance of advisor wherewithal and investor goals. Finally, and perhaps most vital, the Chair must fully understand the term "fiduciary", the associated responsibilities, and the risks. While the Trustees may, many times, foster these perspectives, the Chair must reinforce these vital viewpoints, nurture them, and ensure they thrive to maintain and potentially strengthen Board culture.

DISCUSSION & DECISION-MAKING DYNAMICS

In my view, it is easy to support the notion that the methods by which discussions are conducted and the way in which decisions are determined inside the Boardroom vary dramatically amongst Boards and may spur widely divergent outcomes. It is also fair to say that determining mutually accepted protocols and expected Trustee participation may facilitate more productive, deeper discussions. The goal should be for each Trustee to clearly understand how meetings are conducted, where authority and responsibility lies, what behaviors are encouraged and/or not condoned, and the strategies by which decisions are reached.

One might rightfully ask the question “Don’t educated, experienced business professionals know how to conduct themselves and understand the best ways to reach decisions”? The short answer is clearly “yes”. But, having a common set of expectations can be helpful as not all Trustees may have worked inside organizations which reached decisions in identical ways and have common structures. Furthermore, the goals sought by a Board of fund Trustees do not mimic those of a for-profit corporation or a publicly traded entity or a large public institution, the sources of many Trustees. For instance, the mandate for many Directors of publicly-held companies is to help run the business operationally whereas fund Trustees’ mandate is much more focused on protecting shareholder interests. Therefore, methods do, and should diverge, depending on the goals.

Consider the following scenarios which may affect, positively or negatively, the outcome of a vital discussion regarding a group of mutual funds. Indented, italicized questions or dilemmas posed follow the scenarios, albeit only a sampling.

[Please note that, by including these specific scenarios, I am not indicating that I believe they are widespread. The questions attached to each scenario seek to – perhaps severely – amplify and surface related issues that may require attention or discussion. It is unlikely that the conditions suggested by the scenarios/questions occur frequently or simultaneously.]

An advisor whose Executive personnel are extremely savvy, charismatic and persuasive

> *Is there mutual trust and respect amongst all of the Trustees and an Advisor’s Executive personnel? If not, why?*
>
> *Is the Board inclined to ask for verification or back-up data for claims made by advisory personnel regarding performance and related data, shareholder behaviors, SEC examinations, compliance breakdowns and the like?*
>
> *When discussion topics which are generally not familiar to the Trustees arise, does the Board feel comfortable asking the quintessential “silly questions”, at the risk of appearing to lack basic knowledge? How can this be encouraged (to the extent it needs to be) or does counsel step in?*
>
> *Would most Trustees describe the Board’s relationship with the advisor as “close and personal” or “professional and fully trusting” or perhaps “occasionally skeptical with regular validation”? What is appropriate?*
>
> *Should there be, or is there, an implicit trust amongst the Trustees that the advisor always communicates the ‘whole story’ with accurate facts, realistic depictions, no irrational exuberance, and full candor? Why or why not?*

A strong-willed Chairperson who possesses extensive expertise in the area being discussed

Should all the Trustees implicitly trust him/her and the solutions offered due to his/her status and regardless of their level of independence? Is this approach consistently appropriate?

Should the Trustees generally assume the Chairperson has considered all angles to an issue?

What is the appropriate amount of 'power' and influence effectively garnered by a Chairperson? How might one define possible "abuse of power"?

In general, does the Chairperson encourage and respect rigorous counterarguments from all fellow Trustees? When might this not be a prudent policy?

Does the Chairperson sometimes expect minimal disagreement from fellow Boardmembers when raising ideas or suggesting solutions?

Are issues in the Chairperson's area(s) of expertise simply 'pushed through' without discussion? Why?

Several of the Trustees have expressed frustration with the fact that they 'waste' too much valuable time going through very lengthy, detailed Board materials and have suggested that supplemental Executive Summaries with "exception reports" would enhance their focus

How does a Board reconcile these differences in attitude, perspective, and perhaps willingness to invest (necessary?) time in the position?

To what extent can Trustees rely on high-level summaries as opposed to more detailed information? Should the Trustees always have the 'full materials' for reference while relying on, at their discretion, Executive Summaries? How does counsel feel about relying on Executive Summaries for certain materials?

If summaries are significantly relied upon, will the formal 15(c) record hold up under SEC scrutiny or during litigation?

What specific topics lend themselves to summaries whereby details are getting "too far into the weeds" or considered "micromanagement?" Does potential micromanagement serve to degrade Board/advisor trust and decrease the efficacy of the Board?

A group of Trustees who are rightfully very conscious of their own personal liability as fiduciaries and, furthermore, are extremely reluctant to disagree with Board counsel

When should Trustees disagree with, or aggressively question, counsel, if ever?

Should Trustee business judgment ever trump targeted rules and regulations that may be outdated and/or subject to interpretation?

Under what circumstances should potentially concerning issues be raised and questioned with less concern for personal liability?

Should Trustees always assume that counsel will provide the most appropriate advice in every situation to avoid Board liability? Red flags?

Does counsel disclose clearly to Trustees when they venture beyond their expertise in regulation and rules and offer what are arguably opinions?

How does counsel's expertise in crafting meeting minute documentation play into what is discussed (or consciously avoided, in some cases)?

One Trustee, who is inherently distrustful and frequently plays "devil's advocate" during discussions, slows down and sometimes derails discussions, and asks for inordinate documentation from the advisor

Should the Board fully respect this one Trustee's alternative approach and thus be forced to provide (oral) rationalization for the remainder of the Board's perspectives and decisions (or dismiss him/her as an outlier)?

Should the majority rule most of the time? How might one define "majority"?

Should the Board always require that this Trustee justify his/her reasons for their distrust prior to any divergent discussions?

A Trustee has clearly demonstrated that his/her recall is suspect, judgment is questionable, memory is failing, and participation has diminished

Is there a Board procedure in place (written or otherwise) that places responsibility with a certain party should a Trustee's competence be questioned?

Was this person cited during the Board self-evaluation process?

Do the other Trustees simply let this less-than-optimal Board member continue on until they (hopefully!?) recognize their deficiencies and voluntarily resign?

What should the Board's actions be, if any, if the 'underperforming' individual is embraced by certain Trustees but scorned by others?

This is simply a short, sample list of scenarios that could resonate with some readers and help to surface other similar questions under different conditions. It clearly highlights a small portion of the challenges that Boards may face as watchdogs of mutual funds.

TRAITS of THE 'NON-FUNCTIONING' BOARD?

By raising this topic I am not implying that many 'non-functioning' or perhaps even truly 'dysfunctional' Boards exist in the funds business today. Rather, one way to – perhaps backhandedly – define the structure, qualities, or working methods of a "functional Board" is to ponder what conditions exist inside what might rightfully be considered a non-functioning Board. I would define a Board carrying this moniker as one which does not embody the term fiduciary, does not truly practice shareholder advocacy, does not ever challenge or question an advisor, is incapable of making solid decisions, creates inherently poor intra-Board relationships, and does not fully understand their role as Trustees overseeing an investment company.

Perhaps the most blatant characteristics of a dysfunctional Board are very low participation in discussions over operational, regulatory or performance issues, regular adversarial arguments occur that never reach resolution, there is some level of distrust (perhaps even extreme) by the Board of the funds' advisor (yet management contracts remain in place), and widely-accepted very poor meeting attendance recurs. Indicative of, and possibly as a results of these aforementioned characteristics, there may be an SEC investigation in process that has resulted in long lists of regulatory or rule infractions by the Advisor.

With regard to composition and related skills, non-functioning make take the form of a majority of the Trustees having very close, *personal* relationships with all the Advisor's executives (which may arguably serve to compromise independence and effectiveness); homogenous Board composition precipitating identical viewpoints, oversight strategies, and few rigorous discussions; not one Trustee who truly understands the funds business, the terminology, or the strategies which promote failure or drive success; and Trustees are neither encouraged nor required to attend educational seminars.

Other conditions of a dysfunctional Board may include, but are not limited to, legal counsel who is rarely consulted by Trustees, a Chief Compliance Officer who routinely reports to the Board that no material, regulatory infractions have occurred (very unlikely), all Board meeting agendas are generally very short as there is "really very little the Trustees need to discuss", infrequent meetings between Trustees and key advisory personnel are conducted, and there is rarely questioning of the status quo.

Focusing on dysfunction in the advisory contract renewal process, the Board neither expects nor requests background on investment performance such as "drivers of results" and what might be considered non-competitive expense ratios are sloughed off by the Trustees as a result of "the advisor's above-average cost structure." Furthermore, there is minimal discussion over the content of the "Board 15(c) package", probing Trustee questions do not arise, Executive sessions are not conducted, and the Board oversight record prior to contract renewal approval(s) appears to be thin and lacking sufficient "back and forth."

One might also take the stance that a Board not adequately performing their fiduciary oversight responsibilities has extreme reluctance, as a group, to ask truly probing questions for fear of getting a very concerning or even a less-than-candid response. In some cases, asking too many tangential questions can be detrimental to the process! Broadly speaking, a Trustee should not have significant trepidation about asking their funds' advisor a targeted question about how they run their operations. The Board materials and Advisor discussions should determine if information has been omitted and may hinder the application of a Board's business judgment. Perhaps most important, a determination of holes in the formal record and appropriate questions may be enhanced by candid discussions with counsel and/or a detailed review by an outside party.

Again, this list is only is only demonstrative and serves to reinforce what a Board culture should arguably <u>not</u> be.

IDC STATISTICS ON GOVERNANCE

Released in 2013, the Independent Directors Council released a study entitled "Fund Governance Practices 1994 – 2012" and provided a compendium of statistics on the structure of mutual fund Boards. As indicated by the title, the study sought to uncover how governance practices had shifted – or not – in the 18 years ended in 2012. While the statistics did not focus on culture, per se, it is fair to say that many of the choices that Trustees make regarding composition and formation inherently drive culture.

For instance, consider the following statistics (as of 2012) from the study:

- 85% of all fund complexes have 75% or more Independent Directors
- The % of Boards meeting 5 or more times/year has risen from 8% in 1994 to 33% in 2012
- The average amount of Committee meetings attended by Directors rose from 6 in 1994 to 10 in 2012
- A full 88% of all complexes have an Independent Board Chairperson or Independent Lead Director, or a rise of about 29% since 2004
- Required ownership of shares of the funds overseen is up from 6% to 30% in 2012
- 54% of Boards have dedicated counsel and only 6% have no separate counsel

The movement of these statistics over the course of 18 years clearly shows that Boards have heightened their focus on independence, shoulder heavier workloads, are more likely to have "skin in the game," and rely more heavily on counsel for outside legal opinions and guidance. Each of these essential choices by a Board arguably affect methods or working, focus on certain topics, level of dedication to crucial issues, personal perspective(s), and elevated confidence and conviction in making hard choices.

From a shareholder perspective, it appears that the trends indicated by the IDC statistics are moving in an appropriate direction from a culture standpoint.

OTHER CONSIDERATIONS

A plethora of other questions may surface at Trustee meetings and more informal gatherings – philosophical or otherwise – that, answered thoughtfully, may help to urge a group of Board members towards certain cultural norms. A few examples:

Is an Independent Chairperson beneficial or truly necessary? Is the Lead Independent Trustee model a better choice for some Boards?

Should we require all Trustees to invest in the funds they oversee? If not all, how many? PR issues of non-investment?

What is the retirement policy, if any? Can the Board over-ride under certain circumstances?

How comprehensive and/or rigorous should our D&O and E&O insurance policies be?

How does a Board monitor areas where SEC guidance and regulation is clearly weakest and should they consistently support the SEC's position regardless of its potential for lack of forethought?

Is there a prohibition on Trustees serving on other fund Boards? Should also serving on a non-fund Board be permitted - ?

Should training sessions be mandated for all Trustees and on-going as the business develops?

How should highly personal relationships amongst advisory personnel and certain Trustees be viewed? Should this be discouraged or are there positive aspects?

Does the Board design the structure of the Board reporting materials provided by the Advisor or simply "take what we get?"

Is there a policy on media communication by Board members?

At the risk of micromanagement, at what stage does the Board get involved and/or weigh in on management decisions such as retention of an underperforming portfolio manager, high personnel turnover, inordinate business risks, questionable product roll-outs, non-traditional regulatory schemes or the like?

Should the Board consider themselves a body that needs to help set the levels of advisory fees and profit margins?

Should persons who are ex-employees of the advisor be considered appropriate candidates for the Board? What are the pluses/minuses of such an approach?

By what processes are the auditor and counsel selected?

To what extent does the Board utilize counsel, is their role actively determined, and do they participate in every meeting convened?

If and when do we seriously consider the "nuclear option", if at all?

Do we schedule regular gathering outside the umbrella of "fiduciary" and socialize to initiate and solidify relationships?

What Board operating norms or policies should be documented, if any? [Arguably, judgement need by applied when crafting guidelines, but knowledge of unwritten procedures need to be skillfully handed down over time.]

Once again, these additional Board issues only demonstrate a few of the complexities and variety of issues faced by Boards of mutual funds.

MORNINGSTAR'S GOVERNANCE RATINGS

A valid question that seems to arise in many fund boardrooms across the country is: how does our Board compare to the other Boards across the business? Is our overall investment in our own funds comparable to other Trustees? Do we have the 'right' Committees? Is our composition as diversified as the norm? Is our time dedication in line with other Boards? Is our level of independence (as defined by the '40 Act) like other groups of Trustees? The concept of relative governance 'quality' of a fund complex stacked up against competitive complexes naturally arises. Enter Morningstar with their rating of "stewardship."

Morningstar is the only fund tracking/rating firm that saw fit to use objective and subjective data to rate the largest fund complex's governance quality or adequacy. First Introduced in 2004, a fund firm's "stewardship practices" are now evaluated incorporating the use of an assessment of a fund advisory firm's parent company (graded as "Positive", "Neutral" or "Negative") using the following criteria in one form or another in the grading model:

1. Manager tenure
2. Manager retention rates
3. Manager fund share ownership
4. Firm size overall
5. Individual fund sizes
6. Morningstar Ratings/Success Ratios
7. Firm's growth rate
8. Fund launches
9. Fund liquidations and mergers
10. Morningstar analyst ratings

Broadly and in addition to the above, stewardship grades incorporate the following 5 firm-level criteria generally aimed more directly at Trustee oversight and which Morningstar believes have the "most impact on a firm's stewardship practices." Stewardship grades are bestowed upon Boards ranging from "A" all the way down to "F" (yes, just like school). By incorporating the following 5 broad factors, Morningstar apparently holds the belief that these criteria should be measured in some way – objectively or otherwise – and Boards can meaningfully impact these factors through oversight.

1. "Corporate culture"
2. Fund board "quality"
3. Fund manager incentives
4. Fees
5. Regulatory history

Morningstar's latest stewardship survey (2014) covered approximately 25% of the fund complexes in existence today and may include a "Parent Rating" and/or a "Stewardship Grade" for select fund groups. Primarily the largest fund complexes by total net assets were the focus due to the disproportionate amount of shareholders represented by the largest groups. The authors claim that favorable governance ratings are highly predictive of a more positive shareholder experience, e.g., higher returns, lower fees, small likelihood of regulatory breakdowns etc. In their words "… Morningstar's philosophy is that good stewardship (as defined by their rating algorithm) leads to good investor outcomes."

The criterion **corporate culture** is determined by conversations with management inside a fund company and is arguably a subjective measurement of Morningstar employees' assessment of the Advisor's "appropriate" handling and views on shareholder advocacy, proxy voting, compliance culture, nurturing of people and culture, conflict of interest controls, reporting lines, shareholder service dedication and the like.

Fund **board quality** is measured by a review of Board members' professional backgrounds, educational credentials, certifications, "track record," organizational involvement and the like in an attempt to quantify the "quality" of the group and their ability to serve as effective fiduciaries. I am not aware of any personal conversations with Trustees that may play into this portion of the stewardship rating. This criterion could clearly be considered as supporting a <u>subjective</u> review process and overall Board rating system.

Fund **manager incentives** examines the structures by which portfolio managers are compensated and incentivized to create results which exceed disclosed benchmarks and certainly shareholder expectations. While added detail may be provided to Morningstar by fund company executives beyond what is disclosed in Statements of Additional Information (Part B of filing N-1A), I am skeptical that this phenomenon occurs with any regularity. Incentives that are viewed by Morningstar as appropriate and likely to lead to positive "shareholder outcomes," such as longer performance period comparisons and an equity stake in the Advisor, are given high marks.

The inclusion of **fees** in the grading system is exactly what it seems to be: a measurement of a fund's total expenses within its Morningstar classification and how it stacks up rank-wise against peers. The lower the rank, the lower this component is ranked in the overall stewardship grading system.

Lastly, Morningstar examines the **regulatory history** of the Advisor and makes a judgment about the relative frequency and severity of any reporting deficiencies, compliance breakdowns, administrative judgments, fines, or any other activities discovered by SEC examiners and deemed to not be in line with the regulations or unlawful. Presumably, the infractions uncovered through regulatory history research are 'graded' on a curve since virtually all SEC exams tend to lead to at least one deficiency!

Morningstar offers the investing community and fund sponsor world alike its stewardship grades as a tool for investors to assess Board's presumed effectiveness in overseeing the activities of funds' Advisors or solely informative. Thus, Boards and Advisors have the pleasure of reviewing the results to see if they, in Morningstar's opinion, measure up stewardship-wise.

From a Board's vantage point, the Morningstar stewardship grades do not serve to answer all the relative structure or policy questions a Trustee may have to determine Board norms across the business. In this author's opinion, the grades simply oversimplify the complicated job of oversight and reduce its supposed effectiveness to a letter grade (very much like their fund star system). Most importantly, the subjective aspects of the grading system's formulae and algorithms, e.g., corporate culture, board quality etc., are judgments that could easily be disputed and not necessarily indicative of a Board's true effectiveness. A supposed microscope wielded from downtown Chicago surely pales in comparison to what would have to occur to adeptly measure quality and culture: being in the Boardroom.

[Readers are encouraged to visit Morningstar's website [www.morningstar.com] if they wish to know more detail about the formulae, mechanics, and objective or subjective nature of the stewardship grading system.]

In the case of a Morningstar thumbs-down on stewardship, the larger issue looms …

Should a Board care if they receive a less-than-stellar Morningstar stewardship grade? Perhaps more pertinent, should they alter their policies to arguably pander to the system and elevate their letter grade to support a presumably higher position in the eyes of investors?

In this author's opinion, the answers to these questions is "maybe." Boards should potentially be concerned if they understand that their shareholders are using the parent rating or stewardship grade as a criteria/decision making point in purchasing fund shares and poor marks preclude a fund company from being "in the running." Boards should also be concerned if they personally rate very poorly under the system. If a Board's policies are truly outside the norms in the business and could be considered an "outlier" unwanted risks may be assumed. In the eyes of investors, perhaps other Boards got the model "more correct" - ? Yet, the true value of Trustees as advocates, what really happens inside the Boardroom and the vital decisions that ensue are clearly more critical than what appears to be the 'right structure' to an outsider.

Skillful application of professional judgment and accounting for a complex's unique circumstances and requirements is encouraged.

BOARD SELF-ASSESSMENTS

Mandated by SEC governance rules implemented in 2006, Boards are now required to annually conduct an assessment of their overall effectiveness as a group. Gauging overall Board performance, improving interactions and cohesiveness, and potentially rooting out issues that may impede their ability to optimally perform their duties as Trustees is the goal.

In laying down the requirement for Boards to examine themselves each year, the SEC did not stipulate the required evaluation's structure. Rather, Boards may handle the assessment how they see fit within their own determined format as long as Committees are examined and fund scope is considered. The record must reflect the topics that were discussed, but not necessarily the results and actions undertaken by the Trustees. Full disclosure is clearly not advised and may be the subject of an SEC examination at some juncture. Board counsel should be intimately involved.

The existence of a formal requirement to look at Board performance will clearly drive some aspects of culture within a group of Trustees. Yet, the impact on culture is dependent on how the review in conducted, level(s) of anonymity, individual vs. group focus, who is involved, the level of frankness, and the over-arching goals that are sought. For example, if Trustees understand that personal performance may be scrutinized through the process by design, results and follow-up items will likely diverge from that determined by a more group-focused structure. Setting tangible goals of the performance review and how follow-up will be handled will surely give the process more 'teeth.'

A report by the **Mutual Fund Directors Forum** ("MFDF") entitled "Practical Guidance for Directors on Board Self-Assessments" released in January of 2008 and a Task Force Report authored by the **Independent Directors Council** ("IDC") in February of 2005 together **recommended that Boards consider –** at the very least – the following topics (admittedly abbreviated) during the self-assessment process:

- ✓ Size of the Board
- ✓ Board composition
- ✓ Level of independence
- ✓ Education and experience levels
- ✓ Retirement policy
- ✓ Term limits
- ✓ Board diversity
- ✓ Nominating process
- ✓ Meeting process(es)
- ✓ Committees, structure and their focus
- ✓ Board meeting format, frequency and structure
- ✓ Timing and quality of Board materials
- ✓ Oversight of multiple funds
- ✓ Trustee accountability

- ✓ Board compensation
- ✓ Effectiveness Board-wide
- ✓ Individual performance
- ✓ Action plan post-assessment

While these topics may help to shape a positive Board culture, this is not an exhaustive list of the crucial elements that assist in the formation of culture.

Upon pondering the above and the SEC's guidance in this area, I would submit the following **recommended elements of the process** for readers' consideration and with active formation of a solid culture in mind.

- Determine goals of the performance review at the outset
- Enter the process with improvement in mind, not to simply "check the boxes"
- Enlist a third party to conduct the bulk of the review, as overseen by the Chairperson
- Ensure that counsel is involved in every step of the process
- Fully open, forthright communication should be highly encouraged
- Structure the assessment considering methods which apply best to one's complex
- Intimately involve each and every Trustee, as appropriate
- Support and protect a high level of anonymity
- One-on-one personal interviews/questioning – conducted by an independent party with counsel oversight <u>or</u> simply administered by counsel – are desirable
- Involve Trustees in the crafting of questions
- Questions should include those of a more personal nature such as preparedness, participation, leveraging of expertise, attendance, and engagement
- A high-level summary of the responses to questions should be shared with the Board (the summary may be a substantive source of new ways to set Trustee behavioral expectations)
- Carefully determine the level of self-assessment process disclosure
- Ensure that follow-up items raised by the process are addressed

While not all of these considerations may apply to every complex as "best practices," this author strongly believes that this is a solid list as a starting point for most fund Boards.

WARREN BUFFETT on GOVERNANCE

I was made aware of Warren Buffett's candid opining on fund Directors in early 2003, shortly before the fund trading scandal and Spitzer investigation broke when I read the introduction to the Berskshire Hathaway annual report. Some readers of this white paper and long-time shareholders of Berkshire Hathaway may recall that Mr. Buffett is not only a public company Director in his own right, but also felt compelled to address the competency of mutual fund Trustees in his letter to shareholders dated February 21st, 2003. Regretfully, his observations and commentary were hardly complimentary.

Putting his critique of Trustees' oversight of advisory contracts and fund complex sales aside, the more pertinent commentary involves his observations on Board culture. Consider Mr. Buffett's prose below:

> "Why have intelligent and decent directors failed so miserably? The answer lies not in adequate laws – it's always been clear that directors are obligated to represent the interests of shareholders – but rather in what I'd call "**boardroom atmosphere**."
>
> It's almost impossible, for examples, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his inside staff and outside advisors are present and unanimously support his decision. (They wouldn't be in the room if they didn't.) Finally, when the compensation committee – armed, as always, with support from a high-paid consultant – reports on a megagrant of options to the CEO, it would be like belching at the dinner table for a director to suggest that the committee reconsider.
>
> These "social" difficulties argue for outside directors regularly meeting with the CEO – a reform that is being instituted and that I enthusiastically endorse. I doubt, however, that most of the other new governance rules and recommendations will provide benefits commensurate with the monetary and other costs they impose.
>
> The current cry is for "independent" directors. It is certainly true that it is desirable to have directors who think and speak independently – but they must also be business-savvy, interested and shareholder-oriented. In my 1993 commentary, those are the three qualities I described as essential.
>
> Over a span of 40 years, I have been on 19 public-company boards (excluding Berkshire's) and have interacted with perhaps 250 directors. Most of them were "independent" as defined by today's rules. But, the great majority of these directors lacked at least one of the three qualities I value. As a result, their contribution to shareholder well-being was minimal at best at best and, too often, negative. These people, decent and intelligent as they were, simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation. **My own behavior, I must ruefully add, frequently fell short as well: Too often I was silent when management made proposals that I judged to be counter to the interests of shareholders. In those cases, collegiality trumped independence**."

Clearly, there are many mutual fund Trustee corollaries that arise from Mr. Buffett's observations and opinions on publicly traded Boards. He makes many good points about Trustee qualities and the decision-making process. But, the core issue raised in his commentary relating to independence and shareholder advocacy – applying to both corporate and mutual fund Boards – is that of Board culture. He freely admits that "board atmosphere" seems to precipitate, in himself as well as many others, a propensity to 'go along with the pack' and <u>not</u> necessarily behave in a manner consistent with shareholder interests.

Frankly, it comes as no surprise that in a boardroom setting filled with admirably accomplished people, mutual respect, heightened decorum, widely supported initiatives, and highly refined 'manners,' one lone voice of dissent would be viewed as "bad form" or "a rogue conductor trying to derail the train." But, is that truly the way to view someone with the confidence and moxie to question the majority? Perhaps someone needs to state what many *may* be thinking, but are reluctant to slow down the inertia and considerably lengthen the depth of the discussion and list of considerations - ? As much as all business participants seek out ways to simplify discussions, accept what appears to be the simple, obvious solution, and boost oversight efficiency, details that may be overlooked or purposefully not surfaced can make all the difference in the bottom-line outcome.

In Mr. Buffett's subsequent annual letter to shareholders dated February 27th, 2004, he offered the following advice to fund Trustees, several months after the Spitzer-prompted trading scandal emerged:

> "Let me make a small suggestion to "independent" mutual fund directors. Why not simply affirm in each annual report that "1) We have looked at other management companies and believe that one we have retained for the upcoming year is among the better operations in the field; and 2) we have negotiated a fee with our managers comparable to what other clients with equivalent funds would negotiate."
>
> It does not seem unreasonable for shareholders to expect fund directors – who are often receiving fees that exceed $100,000 annually – to declare themselves on these points. Certainly these directors would satisfy themselves on both matters were they handing over a large chunk of their own money to the manager. It directors are unwilling to make these two declarations, shareholders should heed the maxim "If you don't know whose side someone is on, he's probably not on yours."
>
> Finally, a disclaimer. A great many funds have been run well and conscientiously despite the opportunities for malfeasance that exist. The shareholders of these funds have benefitted, and their managers have earned their pay. Indeed, if I were a director of certain funds, including some that charge above-average fees, I would enthusiastically make two declarations I have suggested. Additionally, those index funds that are very low-cost (such as Vanguard's) are investor-friendly by definition and are the best selection for most of those who wish to own equities.
>
> I am on my soapbox now only because the blatant wrongdoing that has occurred has betrayed the trust of so many millions of shareholders. Hundreds of industry leaders had to know what was going on, yet none publicly said a word. It took Elliot Spitzer, and the whistleblowers who aided him, to initiate a housecleaning. We urge fund directors to continue the job. Like directors throughout Corporate America, these fiduciaries must now decide whether their job is to work for owners or for managers."

As expected, Mr. Buffett offers some reasonable and astute observations, but well-seasoned participants in the funds business may view some of his advice as contrary to what Board counsel would recommend! Yet, his other suggestions, e.g., Trustee investment in the funds overseen, perspective on above-average fees, and a fiduciaries' perspective on "owner's" benefits etc. are well-taken. Clearly, fund Boards work for shareholders and not for fund advisors. The issue of "who does one truly work for" is one that may benefit from regular reinforcement, regular discussions from a (presumed) shareholder welfare or preference standpoint, and cost vs. value proposition analyses.

Reinforcement and reminders about the relentless shareholder focus of a fund Board will create and drive an appropriate culture.

KEYS TO CREATING A DESIRABLE BOARD CULTURE

Considering all the aforementioned structural elements, Trustee attributes, operational policies and the like, what would one conclude is the 'correct' way to consciously promote a healthy, shareholder-focused, efficient board culture? The over-arching themes that emerge from conscious Trustee decisions about structure and the approach to building a Board and promoting a healthy culture include the following:

- ✓ Culture can, to a large extent, be created and fostered through policy and structure
- ✓ A confident, respected, well-educated Chairperson is vital to success
- ✓ Diversity in background, talents, perspective, education, diversity, age etc. can pay dividends
- ✓ Find ways to remind and reinforce the tenets behind which every successful Board operates
- ✓ Don't ever forget the shareholder
- ✓ Trust but verify all information, procure enough information to fully apply business judgment, and don't stay static
- ✓ Care in choosing and educating new Board members can prompt continued success
- ✓ Those Trustees who do not embody constructive participation, the expected decorum, or level of effort should be called-out
- ✓ Committees can provide an effective way to divvy up responsibilities and leverage talent
- ✓ Trustees should freely ask questions, probe for additional information, and have a solid sense of how their Advisor's business operates
- ✓ Executive sessions should be not be considered optional
- ✓ An iron-clad process by which the board conducts its oversight is crucial to success and the affords the ability to deflect litigators' accusations
- ✓ Don't underestimate the value of counsel
- ✓ A respectful, collaborative, and congenial relationship between the Board and the Advisor is an optimal condition and to which should be aspired
- ✓ Boards should be clear amongst themselves on what expected behaviors and level of participation looks like
- ✓ Off-site gatherings of Trustees can help to forge bonds, spur exchanging of ideas, and solidify a Board's functionality

At the risk of sounding redundant, this is also not an exhaustive list, but outlines the highlights.

CONCLUDING REMARKS

Referring back to this white paper's sub-title ("Building an Effective Group of Watchdogs"), this phrase summarizes the goal of this soon-to-be widely distributed 'work.' By penning this white paper, I wish to provide at least some bits of direction and/or advice that may push Boards towards stronger policies that will hopefully strengthen and foster an effective and productive culture. At the very least, I hope readers were given some reasonably novel ideas on governance to ponder and take back to their Boards. Not all concepts may apply to every Board, so customization may optimize the chosen model.

For less seasoned Boards and certainly Trustees new to the business, I hope I have provided a template of what structure should look like and what other elements should be considered. One size does not fit all, but the guiding principles remain the same. Trustees need to understand their vital “watchdog” role and how their skills can benefit shareholders in the most efficient ways possible.

I look forward to opining on more investment company topics in the future and hopefully providing “food for thought” to fund Trustees and the business at large. Readers are encouraged to contact me if they wish to discuss any points raised by this paper.

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Keil Fiduciary Strategies LLC (KFS) is a fund business consulting firm owned and operated by Jeff Keil. KFS seeks to provide third-party opinions and assist fund Boards with issues such as the advisory contract renewal process, fee and expense benchmarking, performance analysis, Board/advisor relations, Board self-assessments, required disclosures, litigation support, and documentation, amongst others. To obtain more information on consulting services offered by KFS please contact Mr. Keil at (303) 662-8180, keil.fiduciary@comcast.net,or visit the firm’s website (www.keilfiduciarystrategies.com).