WILBANKS PARTNERS

Independent Director Recruiting

Best Practice Review

Executive Summary

Recruiting directors for mutual fund boards will need to continue to advance to keep pace with regulatory and market demands. Recruiting will need to address specific technical and functional skills, the growing time commitment required from directors, build on the teamwork abilities of the Board, and to develop more sophisticated decision making criteria as fiduciary and regulatory oversight issues continue to get more complex.

The job of the director is getting harder. The decade long trend of SEC proposals and rulings, accelerating recently regarding CCOs, liquidity, risk and derivatives, makes it increasingly clear that mutual fund trustees are becoming an extension of the regulatory process, as eloquently described by Fink and Edwards.[1] Increased investor, regulatory, and media scrutiny of mutual fund and ETF independent directors is changing the nature of how directors are selected and how they perform as a team. Most importantly, it is nearly impossible to create a "safe harbor" as a fiduciary by simply following the advice of the independent outside counsel. A review of Morningstar's Fund Stewardship Grade process further clarifies the scrutiny that fund directors are under. [2]

Below are some best practices that Boards should consider as they recruit new independent directors.

Breadth of Technical and Functional Skills

Nominating Committees must adopt a skills based competency mapping process, possibly as part of the self-assessment cycle, to make sure that a wide range of technical knowledge beyond a basic knowledge of finance is assembled amongst a small number of available Board seats. Recent rulemaking and guidance by the SEC, FINRA, and the Department of Labor have made executing the governance oversight of mutual funds more complex.[3,4,5,6] It requires expertise in a much wider domain of business activities. Assessment of advisor performance has moved far beyond a review of financial and investment performance for potential conflicts of interest to include forward-looking assessments of all business processes, including compliance (CCO), risk, best execution, liquidity, derivatives, cyber security and valuations. In addition, more sophisticated oversight of distribution activities because of the complexity of sales processes (partly as a result of the DOL fiduciary rule event) is only prudent. At a minimum, directors should possess investment industry specific knowledge about technology, sales/marketing, legal, regulatory/compliance, operations, client service, finance/ treasury management, accounting/control, portfolio management/research, economics, and human capital/compensation.

As an example, the liquidity rule 22e-4 will require directors to consider complex investment and recordkeeping processes at the investment manager, with skills in global capital markets, risk management, quantitative investment processes and treasury management all critical tools.[7] Professional backgrounds in investment banking and capital markets, or treasury management at a sophisticated global bank, would be appropriate.

The DOL fiduciary rule initiative, despite not being formally adopted, has made investment advisor interactions with distribution intermediaries far more complex, and has led to changing share class structures, revised legal documentation, retraining of sales staff, updating of marketing materials, and a rebuilding of technology interfaces. Boards that lack directors with related distribution experience could have significant difficulty understanding these nuances or asking the right questions as they assess whether advisor ongoing best practices in this area are adequate.

Time Commitment

New directors need to be available for all meetings and must be prepared to make a significant time commitment to the role. This time commitment is likely to be at least 200-300 hours per year, double what was expected just 10-15 years ago. The stakes are rising in the face of added investor and regulatory scrutiny. Numerous shareholder lawsuits that name directors for inadequate supervision drive this point home. Exercising adequate due diligence in the face of greater transparency and changing market requirements is simply more time consuming.

Board best practices are beginning to increase the number of committees, use of professional services experts, and the amount of time in meetings directly with the management of the investment advisor as a result of these building regulatory requirements. There are questions about whether four single day Board meetings with a “committee of the whole” used for audit and nominating with a half day set aside for 15c deliberations, supported by outside legal counsel and independent accountants will remain adequate. It is more likely that Boards will meet for 8-10 days per year, set aside two full days for 15c deliberations, and that separate Committee meetings for Audit, Compliance, Governance/Nominating, Risk/Valuation/Derivatives, Distribution and Cyber/Technology will be created with an additional 2-4 meetings per year each, with each committee supported by specialist consultants in the field of the committee’s responsibilities.

Teamwork

New fund directors must work well within the existing Board team. As independent directors work harder to satisfy their fiduciary duties, it becomes more important for them to function as a team and not as a loose confederation of experts. Character traits that ease this process include excellent communication skills, strong ego, sense of humor, cultural discernment/emotional IQ, empathy and team-building skills.

Once the Board is assembled, getting the group to work together successfully and improve over time is as much art as it is science. Onboarding exercises with the current Board members and the investment advisor management team are important and becoming a standard part of the recruiting cycle. They can help new directors become better acquainted personally and professionally with their peers and will help them understand their overall performance expectations.

Performance metrics available to the Board through peer reviews and executive assessments are critical to encouraging peak performance, as no director wants to be admonished for lagging on the job. Though self-assessments are now part of the regulatory structure, independent directors should use leadership assessment experts to assist them in making these reviews more impactful in guiding the culture of the team.[8, 9]

Business Judgement

Independent directors should have strong leadership and management track records to facilitate independent decision making in complex business situations. They will be required to listen carefully to the presentations of the leadership of the investment advisor and their experts, but they should routinely meet with other “C-suite” leaders and critical investment advisor team members independently in executive session. They need to utilize the skills of a growing number of independent outside experts beyond the auditors and legal counsel, probably to include experts in compliance, risk, technology, valuations, capital markets and distribution.

It is necessary for the independent director to be capable of asking difficult and probing questions of the investment advisor's management team, outside professional experts and their peers on the Board, in order to grasp to the essence of issues necessary for decision making. However, it is equally important for the Board to make all key decisions on a unanimous basis, with compromise frequently required, as they reach conclusions about the efficacy and preparedness of the advisor's business processes. Lastly, board members must never loose sight of their governance role as a strategic advisor working through influence, rather than attempting to manage issues directly.

Conclusion

Boards need to invest continually in more aggressive and forward looking recruiting practices in order to achieve these goals. They cannot wait for a retirement or crisis to put in motion many of these initiatives.

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Notes

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