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OPINION
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Guest Comment

Oversight could prevent mutual fund problems

Brian Breidenbach, CPA, CFA

Surprised to find out that many mutual funds have been snatching from their investors' personal cookie jars? You shouldn't be.

The mutual fund industry is fraught with a lack of independent oversight. Combine this with regulatory authorities' inabilities to keep pace with the substantial growth of the fund industry, and conditions have become ripe for illegal and unethical activities to go unnoticed.

The recent fund trading scandal is yet another red tide of malfeasance by the investment industry washing to shore. What makes this latest stench so pungent is lack of oversight by regulators.

Problems with industry should be aired

The problems of the fund industry mirror the issues we have seen with public companies. Years before this scandal, many raised issues with the lack of independent oversight within the fund industry.

The U.S. Securities and Exchange Commission actions to quickly settle with fund companies have drawn ire in The Wall Street Journal. Problems within the industry need to be aired out, not swept under multi-million-dollar settlement rugs.

The fund industry controls more than $7 trillion for millions of investors. Problems need to be addressed by long-term solutions, not by quick fixes.

If the SEC is unable to execute its duties, how do investors achieve better oversight? The following measures should be used to improve the oversight of the fund industry:

- Representation by qualified independent directors;
- Limits on terms and number of boards;
- Improved disclosures.

Qualified independent directors

A Kiplinger publication noted in a 1997 article that current "independent" fund directors may not be independent or qualified.

Many times directors count as independent, but a careful examination of their history may show that they are a retired executive with the fund or an affiliated company.

Fund experience or extensive investment knowledge is not a prerequisite to serve as a fund director.

Kiplinger addressed this, as well: "It's logical that board members should come from the financial services industry and know their fields well."

MPI, a consultant to mutual fund boards, comments that boards need an "increasing level of professional knowledge" and that they have exceptional fiduciary responsibilities, which are greater than corporate directors.

Like audits of public companies by independent accounting firms, all fund boards should have at least one independent director who is qualified by a credential that is founded in investment knowledge and bound by a stringent code of ethics.

The globally recognized Chartered Financial Analyst (CFA) credential fits this need.

The CFA designation is the most qualified to evaluate a mutual fund's performance, fees and management. It is the only designation Morningstar recognizes as a qualification for mutual fund managers.

Benefits of having a CFA charterholder at the helm have been documented in several pension fund studies, which also should transcend into the fund industry.

Term and number of board limits

Limits should be placed on both the number of funds and terms an independent director can serve.

Time limits tie director compensation to the time directors serve. The current director compensation system rewards deadwood via a "loyalty bonus" for voting the side of the fund company.

Limiting the number of funds an independent director serves would allow a more detailed focus on investor issues.

The old cliché of not spreading yourself too thin should apply.

Increased disclosures

The current prospectus system of "disclosures" is a document that only drafting lawyers can love.

Fees, trading costs and conflicts of interest should be spelled out, not buried in the litter box of footnote disclosures allowed in the current system.

The independent CFA charterholder director could file a separate annual report to the SEC for Web posting. Although subject to opinions, the independent filing would provide insight the investing public is not currently receiving.

This independent report could cover areas such as fee justification, trading costs, performance and risk relative to stated fund objectives.

Better governance is needed

The magnitude of the issues faced in the current scandal could have been eliminated through better governance.

Emphasis on shareholder rights should be the ultimate focus.

Adding qualified independent directors and with improved disclosures would bring us light-years ahead. Term and board limits allow for fresh input and oversight that can only improve the system further.

Although increased shareholder rights may never completely temper our human fits of "fear and greed" as investors, with the right elixir, the investing industry can limit its temperamental mood swings.

Brian C. Breidenbach, CPA, CFA is the managing principal of Breidenbach Capital Consulting LLC, a fee-only investment advisory/consulting firm serving the needs of individual and institutional investors. He can be reached at (502) 561-3411 or brian@4bcap.com.