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Board structure, mergers, and shareholder wealth: A study of the mutual fund industry☆

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Abstract

We study mutual fund mergers between 1999 and 2001 to understand the role and effectiveness of fund boards. Some fund mergers—typically across-family mergers—benefit target shareholders but are costly to target fund directors. Such mergers are more likely when funds underperform *and* their boards have a larger percentage of independent trustees, suggesting that more-independent boards tolerate less underperformance before initiating across-family mergers. This effect is most pronounced when *all* of the fund's directors are independent, not the 75% level of independence required by the SEC. Higher-paid target fund boards are less likely to approve across-family mergers that cause substantial reductions in their compensation.
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1. Introduction

Recent scandals involving US mutual fund companies have elevated concerns among fund regulators and pundits regarding the effectiveness of mutual fund boards the so-called watchdogs of shareholders' interests. To better protect the interests of fund shareholders, the Securities and Exchange Commission (SEC) voted on June 23, 2004 to require that chairpersons of mutual fund boards be independent of the investment advisory firm affiliated with the fund. In addition, the SEC required that at least 75% of the mutual fund directors be independent.[1] The previous requirement was 50%. The US Chamber of Commerce objected by filing a lawsuit opposing the changes; according to its general counsel, "There's no empirical evidence that an independent chairman or a 75% majority will have a positive effect on the performance of mutual funds".[2] Two of the five SEC commissioners also objected, arguing that there was little empirical data to support such drastic changes in fund governance policies.

Nonetheless, there *is* some evidence that addresses whether fund boards with certain structural characteristics perform differently. Examining open-end fund companies from the 50 largest fund complexes, Tufano and Sevick (1997) document that fund fees are smaller for funds overseen by smaller boards and boards with a larger proportion of independent directors. Del Guercio, Dann, and Partch (2003) document similar evidence for closed-end mutual funds. Zitzewitz (2003) finds that the adoption of fair value pricing, which protects investors from market timing, is negatively related to the percentage of insiders on the board, suggestive of agency problems inherent in fund organizations. These studies look at fee setting and pricing policies because regulations empower fund boards to oversee or make such decisions.

In this paper, we examine another fund decision where boards play a critical role: the decision to merge a fund out of existence. Using a cross-section of fund boards in the 1999–2001 period, we examine the relation between mergers and board structure. We motivate this work by examining the consequences of mergers of funds for their shareholders and trustees. We primarily focus on target funds in across-family mergers, i.e., mergers between acquiring and target funds belonging to different fund families, because these mergers typically reflect an organizational restructuring rather than a mere reshuffling of funds within a complex. Consistent with earlier studies, we find that fund mergers—especially across-family fund mergers—tend to be value enhancing for target fund shareholders. However, these mergers are costly for the trustees of these merged funds, who lose board seats and compensation. Given this possible tension between the board's private interests and its fiduciary duties, certain governance traits might enhance a board's willingness to take actions that are personally costly but beneficial for shareholders. Specifically, we study whether boards that are thought to be more independent or effective are more likely to take such actions promptly. We also study whether boards for whom merging is more costly, in terms of a prospective loss in director compensation, are less likely to merge themselves out of a job.

[1]Under the Investment Company Act, an independent director, cannot be: an employee of the adviser or a member of the immediate family of an employee; an employee or a 5% shareholder of a registered broker-dealer; or affiliated with legal counsel to the fund.

[2]See http://www.uschamber.com/press/releases/2004/september/04-118.htm for the Chamber of Commerce's position. This quote comes from http://www.contracostatimes.com/mld/mercurynews/2004/09/03/business/9571467.htm (visited October 11, 2004).

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