



# **A Cost-Benefit Analysis on the Introduction of Independent Review Committees for Mutual Funds**

(Proposed Methodology)

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## Introduction and executive summary

*“Everything should be made as simple as possible, but not simpler.”*

*--Albert Einstein*

This cost-benefit analysis will quantify the costs and benefits of introducing a rule (the Proposed Rule) requiring all mutual fund managers to establish an Independent Review Committee (IRC). The IRC would review all transactions involving a conflict between the interests of the fund manager and fund investors. IRC review replaces the current conflict of interest rules but it will capture much more than just related-party transactions.

### The costs

The data for our cost analysis has two sources:

1. A survey of Canadian mutual fund companies with some form of fund governance structure (such as an advisory board, individual trustees, or a registered trust company) in place
2. Canadian data on corporate directors (see **Cost Analysis**)

Overestimating the costs, we concluded that the total industry cost of setting up and operating an IRC structure would be \$166.4M. This amount is the hurdle that has been set for the benefits to overcome.

### The benefits

Empirical research from the U.S. has shown that oversight by an independent group is an effective way to handle conflicts of interests. However, we are sensitive to the fact that the U.S. fund governance regime is quite dissimilar to the Proposed Rule. This left us with us with limited research we could apply to the Canadian context.

### What is cost-benefit analysis?

Cost-benefit analysis is a diagnostic tool. Our goal is to determine whether there is a definite region where the costs associated with an initiative outweigh its benefits or, alternatively, where the benefits outweigh the costs.

We endeavor to create a reliable model, not a perfect one. To do this, we must distill an initiative into its major components.

Our first task is to quantify as many of the costs and benefits as possible. If we can quantify most of the relevant costs and benefits and if one clearly outweighs the other, our analysis can end there. However, if this is not the case, we use qualitative costs and benefits to add more information to the picture. The analysis continues until a definitive outcome (positive or negative) can be determined.

When completing a cost-benefit analysis, we always overestimate the costs and underestimate the benefits. In other words, we take a very conservative approach so that we get clear, unequivocal results.

A conservative approach also ensures that our results stand-up, even if our underlying assumptions are less than perfectly accurate, if market conditions suddenly change, or if there are unanticipated costs that we didn't take into consideration.

The CBA process is a work-in-progress that can be refined with new input and suggestions, such as from this comment period.

We will construct an economic model to quantify the benefits associated with introducing an IRC. The model will be designed to test factors that may impact on a fund's performance or return. Such factors will include the fund manager's ability, overall market performance and the inflow of distributions and dividends from fund holdings. The model will be comprised of established indicators reflecting these attributes. A governance attribute will be included into the model to test the hypothesis that governance also influences a fund's performance or return. The results will be generated using regression analysis, a standard statistical technique (see **What is regression analysis?**). Regression analysis will estimate how well a given model or equation explains observed behaviour, as represented by observations in a dataset.

Economic literature tells us that board activity (represented by the frequency of meetings) is a good signal for the effectiveness of a board's monitoring function. For this reason, we use the frequency that a board meets as a signal for the board's effectiveness.

The benefits of removing the existing conflict of interest rules are captured in the report by Keith A. Martin entitled, [\*Mutual Fund Governance Cost Benefit Analysis – Final Report\*](#). The benefits however are contingent on effective oversight by IRCs. We believe the low-end cost savings from relaxing restrictions on related party transactions and inter-fund trading at \$85 million will offset part of the high-end cost estimate for setting up IRCs (figures are annual and include unamortized initial outlays).

### What is regression analysis?

Regression analysis is a statistical technique used to determine whether a given model explains, or is consistent with, the observed behavior (e.g. observations in a dataset) and how accurately it does so.

The dataset gathered will reflect the observed behavior that we wish to examine. The statistical tests judge the model's ability to represent or describe the observed behavior, as a whole, and each variable's ability to explain or influence the model. If a variable is statistically significant, the estimated coefficient represents that variable's influence on the model.

A relatively large dataset is necessary to take our analysis from the realm of anecdotal evidence (e.g. a case study of a few funds) to something statistically sound. This is important because we want our results to be representative of the entire fund universe.

## 1. Issue to be addressed

The Canadian Securities Administrators (CSA) propose to mandate the creation of IRCs. It is hoped that subjecting transactions touched by conflicts of interest to independent review will enhance investor protection. At the same time, the CSA wish to promote market efficiency by replacing the restrictive related-party prohibitions with the more flexible IRC approach. We ask: will the benefits of the Proposed Rule outweigh its costs for the industry? What about smaller mutual fund managers who do not engage in related-party transactions?

## **2. Success measures**

We will test whether the introduction of an IRC has an impact on fund performance. If it does have an impact, we are very interested to learn whether it is positive or negative.

## **3. Cost Analysis**

The cost analysis is relatively straightforward. We know that a number of Canadian mutual fund managers already have some form of voluntary fund governance. We started by surveying these 28 managers to find out what their boards look like and how much they cost to set-up and run. We use this information as the low end of the possible cost range.

For the high end of the cost range, we looked to data on Canadian corporate boards. Of course, a corporate board has duties and responsibilities far more onerous than those proposed for an IRC. This ensures that our costs estimates are more than ample.

Low and high range costs were estimated by applying the assumptions below. The total industry cost of introducing IRCs was calculated after determining the initial set-up costs and the subsequent operating costs. The figures below are annual costs.

### **3. A) Assumptions**

#### **The sample universe**

The sample universe we used consists of the 140 mutual fund managers. There are 25 members with assets over \$2B. We refer to these as “large” fund managers. There are 115 members with assets under \$2B. We refer to these as “small” fund managers.

#### **Large managers vs. small managers**

We assume that the IRCs for large fund managers are structured very much like a corporate board, with sub-committees. The IRCs for small managers are assumed to have no sub-committees.

#### **Liability and insurance**

We felt comfortable using insurance data from the corporate sector because, from the insurer’s perspective, the fund manager’s directors and officers present a much greater risk than the IRC members do. The limited responsibilities of IRC members may mean that they can be insured under the manager’s D&O policy with only a minimal impact on the price of that insurance. Typical practice is to provide liability insurance for board members as part of their corporate D&O policy. Since IRCs will have duties and responsibilities that are far less onerous than that of corporate boards, their exposure to litigation risk should be limited. We note that 45% of small managers and 18% of large managers with an existing governance board do not have insurance coverage for board members. This was used for the low-end estimate.

### 3. B) Operating cost per firm

<b>Table 1: Large Firms</b>	<b>Total (Low range)</b>	<b>Size / unit costs</b>	<b>Total (High range)</b>	<b>Size / unit costs</b>
Firms		25		25
Board Size		3		10
Chair Retainer	130,000	130,000	250,000	250,000
Directors		2		9
Board Retainer	30,000	15,000	270,000	30,000
# Meetings		2		9
Meeting Fee	7,986	1,331	126,990	1,411
# Committees		1		8
Committee Chair	5,044	5,044	69,352	8,669
Committee Size (incl. Chair)		2		10
Committee Retainer	3,531	3,531	291,384	4,047
Committee Fee	4,916	1,229	955,440	1,327
Insurance	62,219	75,876	99,222	99,222
Legal	75,000	75,000	75,000	75,000
Admin	30,000	30,000	30,000	30,000
<b>Operating cost per firm</b>	<b>348,696</b>		<b>2,167,388</b>	
<b>Table 2: Small Firms</b>	<b>Total (Low range)</b>	<b>Size / unit costs</b>	<b>Total (High range)</b>	<b>Size and unit costs</b>
Firms		115		115
Board Size		3		10
Chair Retainer	30,000	30,000	130,000	130,000
Directors		2		9
Board Retainer	30,000	15,000	270,000	30,000
# Meetings		2		9
Meeting Fee	7,986	1,331	126,990	1,411
Insurance	29,767	54,122	54,122	70,774
Legal	75,000	75,000	75,000	75,000
Admin	30,000	30,000	30,000	30,000
<b>Operating cost per firm</b>	<b>202,753</b>		<b>686,112</b>	

### 3. C) Set-up cost per firm

Setup costs are one-time expenditures associated with the cost of establishing and populating the IRCs. Costs for small fund managers are probably overstated, since they are more likely to recruit directors from their network of business contacts to avoid these costs.

<b>Table 3: Setup Cost</b>	<b>Small: low</b>	<b>Small: high</b>	<b>Large: low</b>	<b>Large: high</b>
Search cost per director	-	15,000	22,378	22,378
Legal	75,000	75,000	75,000	75,000
Directors	3	10	3	10
<b>Setup cost per firm</b>	<b>75,000</b>	<b>225,000</b>	<b>142,134</b>	<b>298,780</b>

### 3. D) Total industry cost

Table 4 groups the total cost to the industry by size of a fund family's assets. Table 5 combines the results of Table 4 to arrive at low range and high range industry cost estimates.

<b>Table 4: Total industry cost by fund family size</b>	<b>Small: low</b>	<b>Small: high</b>	<b>Large: low</b>	<b>Large: high</b>
Total setup cost	8,625,000	25,875,000	3,553,350	7,469,500
Total operating cost	23,316,584	78,902,838	8,717,391	54,184,703
<b>Industry cost by family size</b>	<b>31,941,584</b>	<b>104,777,838</b>	<b>12,270,741</b>	<b>61,654,203</b>

<b>Table 5: Total industry cost</b>	<b>Industry: low</b>	<b>Industry: high</b>
<b>Total industry cost = small + large</b>	<b>44,212,325</b>	<b>166,432,041</b>

## 4. Benefits Analysis

We intend to quantify the benefits associated with IRC review by creating an economic model. This model will test variables that may have an impact on a fund's performance or return, including a variable measuring board activity, which we call the fund governance variable. The governance variable tests to see if it has an additional impact on fund returns, beyond the other variables chosen.<sup>1</sup> The results are generated using standard regression analysis.

If the fund governance variable is found to be statistically significant, after we have accounted, or controlled, for the variables that are generally considered to affect fund performance, we could conclude that fund governance has an incremental impact on a fund's performance. The regression analysis will determine how significant the impact is and whether that impact is positive (providing additional benefits) or negative (providing additional costs) to the present system.

### 4. A) Theoretical basis for economic model

The present regulatory framework does not require fund governance. However, a number of fund managers do have voluntary boards, ranging from advisory committees to independent trustees who oversee management. After conducting a detailed survey of each of these governance boards, we found that none of the factors surveyed showed enough statistical consistency to be tested. In other words, we had a statistically useful sample of governance, but were unable to test the detailed factors that make up a governance agency. In this environment, it would be difficult to control for unintended influences between the governance variables.

<sup>1</sup>One would initially assume that a rule requiring the creation of an IRC would negatively influence fund performance because we know it costs money to create and run an IRC. The fund would pay out these costs and should have a negative impact on fund performance.

Therefore, the variable used in our study must account for the wide array of governance structures and standards developed in an unstructured environment. The chosen variable should not be sensitive to these underlying differences.

Economic literature suggests that board activity is a good proxy for the effectiveness of a board's monitoring function. Effective monitoring, in turn, provides a good indication of a board's effectiveness. We chose to look at the number of meetings held by a board during the course of a year as a proxy for board effectiveness. Our decision was guided, in part, by the work of the following academics:

Conger et al (1998)<sup>2</sup> suggested that board-meeting time was a scarce yet important resource in improving board effectiveness. Lipton and Lorsch (1992)<sup>3</sup> suggested the most widely shared problem faced by directors was the lack of time to carry out their duties. Jensen (1993)<sup>4</sup> observed that routine tasks limited the time that outside directors could exercise meaningful control over management.

Vafeas (1999)<sup>5</sup> demonstrated that boards meet more often during periods of turmoil, and that boards meeting more often would show improved financial performance. A board that meets more often should be able to devote more time to issues... A board that seldom meets may not focus on these issues and may perhaps "rubber-stamp" management plans (Vafeas, 1999). He concluded that boards met more after poor performance, reaffirming Jensen's (1993) suggestion that meetings were a reactive response and not a proactive measure.

Menon and Williams (1994)<sup>6</sup> argue that it is not enough for committees to be independent (in their case, audit committees)—they must also be active. An independent audit committee that never meets is of little consequence. The suggestion is that in examining the issue of independence, it is also important to consider the level of activity. They used the number of meetings as a proxy for the level of activity. They note that the number of meetings is a rough proxy for activity since it does not provide any indication of the work accomplished during these meetings. They also noted that committees that did not meet or meet only a small number of times were unlikely to be effective monitors (Deli et al, 2000)<sup>7</sup>.

Xie et al (2003)<sup>8</sup> findings were consistent with the hypothesis that an active board is a better monitor than an inactive board. He expected that more meetings would be associated with

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<sup>2</sup> Conger, J., Finegold, D., Lawler III, E., 1998, Appraising Boardroom Performance, *Harvard Business Review* 76, 136-148

<sup>3</sup> Lipton, M., Lorsch, J., 1992, A modest proposal for improved corporate governance, *Business Lawyer*, 48 (1), 59-77

<sup>4</sup> Jensen, M., 1993, The modern industrial revolution, exit, and the failure of internal control systems, *Journal of Finance*, 48, 831-880

<sup>5</sup> Vafeas, N., 1999, Board meeting frequency and firm performance, *Journal of Financial Economics*, 53(1), 113-142

<sup>6</sup> Menon, K., Williams, J.D., 1994, The use of audit committees for monitoring, *Journal of Accounting and Public Policy*, 13, 121-139

<sup>7</sup> Deli, D.N., Gillan, S.L., 2000, On the demand for independent and active audit committees, *Journal of Corporate Finance*, 6(4), 427-445

<sup>8</sup> Xie, B., Davidson, W., DaDalt, P., 2003, Earnings management and corporate governance: the role of the board and the audit committee, *Journal of Corporate Finance*, 9 (3), 295-316

more effective monitoring of issues, such as conflicts. A board that meets more should be able to devote more time to these issues (Xie et al, 2003).

#### **4. B) Considerations in methodology**

Although a number of Canadian mutual fund companies have some form of fund governance, none of the existing structures would be in total compliance with our Proposed Rule. Many of these governance boards do far more than we would require while some do less. For this reason, we must be careful if we are to draw on this data for our benefit analysis.

At the same time, we recognize that it is probably quite safe to assume that the benefits of our proposed rule would fall somewhere within the existing range of benefits enjoyed by fund managers who have voluntarily adopted some form of governance. Given this fact, it is probably quite safe to use the very low end of the range of benefits in our analysis because it would almost certainly be lower than the total benefits (quantitative and qualitative) generated by the Proposed Rule.