Differentiating Control, Monitoring and Oversight: Influence of Power Relations on Boards of Directors – Insights from Investment Fund Boards

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Abstract

Purpose – Boards of directors are assumed to exercise three key accountability roles – control, monitoring and oversight roles. By researching one board type – investment fund boards – and the power relations around those boards, the purpose of this paper is to show that such boards are not capable of operating the three key roles assumed of them.

Design/methodology/approach – The authors conducted 25 in-depth interviews and a focus group session with investment fund directors applying a grounded theory methodology.

Findings – Because of their unique position of power, the authors find that fund promoter organisations (that establish and attract investors to the funds) exercise control and monitoring roles. As a result, contrary to prior assumptions, oversight is the primary role of investment fund boards, rather than the control role or monitoring role associated with corporate boards. The findings can be extended to other board-of-director contexts in which boards (e.g. subsidiary boards, boards of state-owned entities) have legal responsibility but limited power because of power exercised by other parties such as large shareholders.

Practical implications – Shareholders and regulators generally assume boards exercise control and monitoring roles. This can lead to an expectations gap on the part of shareholders and regulators who may not consider the practical realities in which boards operate. This expectations gap compromises the very objective of governance – investor protection.

Originality/value – Based on interviews with investment fund directors, the authors challenge the control-role theory of investment fund boards of directors. Building on our findings, and following subsequent conceptual engagement with the literature, the authors differentiate control, monitoring and oversight roles, terms which are often used interchangeably in prior research. We distinguish between the three terms on the basis of the level of influence implied by each.

Key Words: Board of directors, Accountability, Control, Monitoring, Oversight, Power

1. Introduction

Corporate boards of publicly listed companies are assumed to have full power to exercise three key accountability roles – control, monitoring and oversight roles. These assumptions may not be applicable to the boards of other types of entities. Yet these taken-for-granted assumptions are often extended to other board types (see examples in Table II). Acknowledging this, scholars have repeatedly called for research on boards of directors beyond listed company boards (Daily *et al*., 2002; Dalton *et al*., 2007). Brennan and Solomon (2008) observe that "The way that other types of organisations have been directed and controlled has not been the primary focus of accounting and finance researchers". By studying one extreme board type, we identify constraints on the way investment fund boards operate, which may be relevant to some other board types and situations.

Corporate governance is a complex system of moving parts, with boards of directors as the central governance mechanism. However, boards' power limits may constrain their assumed ability to exercise control, monitoring and oversight roles. Understanding the limitations of boards of directors' role has implications for other governance mechanisms in that complex system. Citing Herman (1981), Mizruchi (1983, p. 432) observes: "control operates under a system of constraints". By researching investment fund boards, which have limited power in practice, we obtain new theoretical insights on the differences between control, monitoring and oversight roles.

Assuming that boards can exercise control is in many cases a myth (e.g. Roberts et al. 2005). It is important to understand board power limits in practice, otherwise there is a risk of an expectations gap on the part of investors, regulators and researchers between what boards are expected to do vs what they are capable of doing (Brennan, 2006). Such an expectations gap can, for example, lead to investors not exercising their governance roles because they assume others are doing it for them; and to regulations that assume governance roles incapable of execution in practice.

Theoretical insights from investment fund boards may be applicable to other types of boards whose power is limited, often as a result of the power dynamics around the board (e.g. subsidiary boards, boards of state-owned entities, boards with large powerful shareholders).

The research addresses two questions:

RQ1. Given their unique characteristics, is the assumption that investment fund boards have a control role appropriate?

RQ2. What roles do investment fund boards exercise in practice?

The unexpected findings of our research challenges the control-role assumptions of prior empirical research on investment fund boards of directors. There is a wide variety of other governance contexts where the empirical research agenda needs to reflect the practical realities of board roles and role execution, including selection of appropriate dependent and independent variables. This should lead to less ambiguous and stronger empirically generated results that help inform regulatory policy.

Our study makes three contributions: first, we examine the role of investment fund boards customised to the context in which these boards operate. By linking the unique characteristics of investment funds to investment fund board roles, we enhance theoretical understandings beyond prior research. Second, based on interviews with investment fund directors, we add novel and unexpected insights on investment fund (and other) board roles not factored into prior investment fund board empirical research; specifically, that investment fund boards can only exercise oversight roles and are not able to control or monitor. Third, the terms “control”, “monitoring” and “oversight” are differentiated and separately defined. The distinction is important as we find that investment fund boards can only exercise oversight functions, which finding is likely to apply to other types of entity where there is a power imbalance.

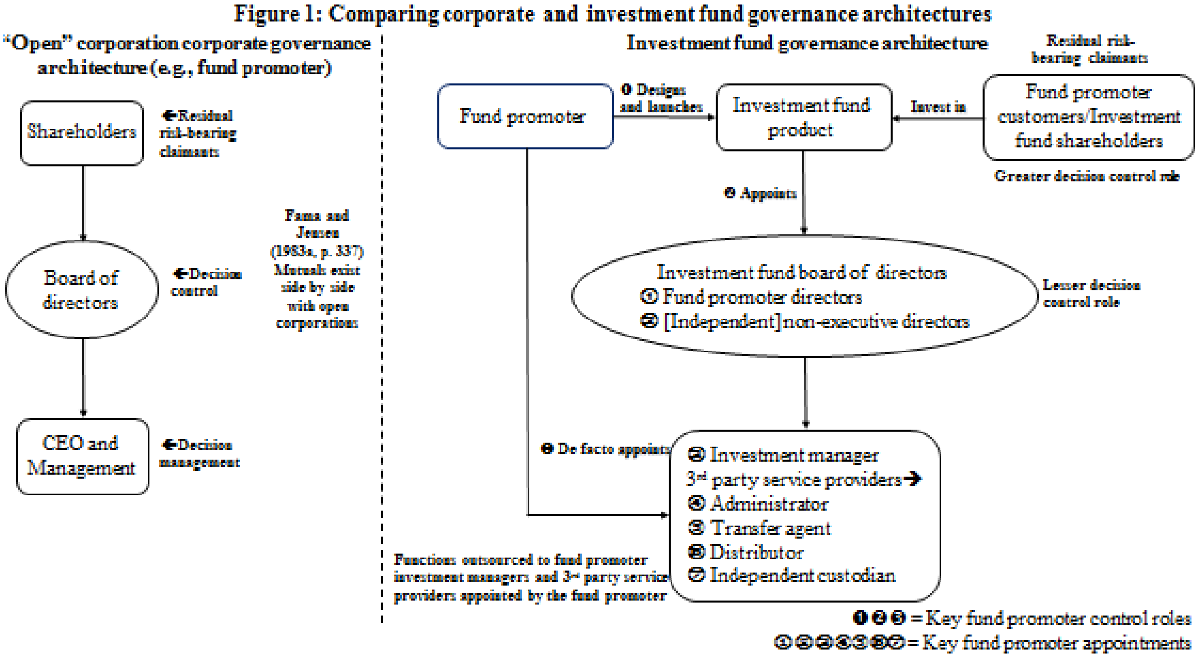
The paper is organised as follows. We discuss the investment fund context in Section 2. Section 3 reviews prior research on investment fund boards and considers the issue of power and boards of directors. Section 4 outlines the grounded theory methodology. We discuss our findings in Section 5 and conclusions are drawn in Section 6.

2. The investment fund context

By investment funds (sometimes called “mutual funds” or “collective investment schemes”), we mean regulated “funds operated by investment companies that gather money from shareholders to invest in stocks, bonds, and other securities” (i.e., the collective funds) (Kim 1998, p. 479). The worldwide regulated open-end investment fund sector is significant, amounting to €43.2/US$51.6 trillion at end of March 2017 (European Fund and Asset Management Association, 2017). Better understanding of how the boards of these significant entities work is therefore important.

A key unique characteristic illustrated in Figure 1 is that investment funds are investment products created by fund promoter organisations. Fund promoter organisations (such as Goldman Sachs, Federated and Fidelity) house numerous mutual fund products/companies (“fund families”), launch the investment products, prepare the fund prospectus and attract customers/investors to the fund by virtue of fund promoter organisations’ reputation. Typically, each product is legally constructed as a company with a board of directors (Roiter, 2016)[1], often established following the design, launch and preparation of the fund prospectus. Thus, investment fund boards of directors have little or no input into these critical activities, reflecting their limited power. A second unique characteristic is that fund promoter customers are the investors/shareholders in the investment fund. Unlike customers of corporations (for example, customers of banks), investment fund customers/investors as fund shareholders have a direct shareholder control role in that they can at any time redeem their claims at the fund’s net asset value (Roiter, 2016). If investment fund customers/investors redeem their claims, the assets in the fund will fall by the claims redeemed. In listed companies, investors selling their shares has no direct impact on the net assets in the firm. That investment fund customers are also their shareholders creates a unique relationship between investors and fund promoter organisations, making investment funds particularly interesting from a governance perspective. A third unique characteristic is that investment funds typically outsource core activities to specialist service providers (fund promoter-related investment managers and third party service providers – ③ to ⑦ in Figure 1). A direct consequence is that investment funds typically have no employees. Thus, the main role of investment fund boards is to oversee the functions outsourced to the fund promoter and to third party service providers, in particular the multiple conflicts of interest that arise from these outsourced arrangements. A fourth unique characteristic is that fund promoters select the directors of the investment fund (① and ② in Figure 1).[2] This contrasts with the practice in listed companies of nomination committees, generally comprising independent non-executive directors, selecting the independent non-executive directors to be put to shareholders for appointment at the annual general meeting. Selection of directors by fund promoters is especially problematic given the significant conflicts of interest between fund promoters and investors. These unique characteristics are reflected in Figure 1 which compares the different governance architecture of companies and investment funds. Figure 1 particularly highlights three key fund promoter control roles: ❶ they design and launch the investment products, ❷ investment products are separate companies within the fund promoter governance architecture which have their own board of directors; ❸ investment managers are typically divisions or employees of fund promoter organisations.[3]

Figure 1: Comparing corporate and investment fund governance architectures



The unique characteristics of investment funds create knock-on unique characteristics for their boards of directors. Investment fund boards operate very differently to corporate boards. Investment fund boards exist side-by-side with the main board of the fund promoter organisation (see Figure 1). Investment fund boards comprise two groups of directors, all appointed by the fund promoter organisation: fund promoter directors who are employees of the fund promoter organisation; and non-executive directors who may/may not be independent. Investment funds typically have no employees because all functions are outsourced. While the investment managers and third party service providers are legally appointed by investment fund boards, they are *de facto* selected by fund promoter organisations. Investment fund boards of directors have limited control by virtue of the fund promoter control role through fund promoter organisations' main boards; the investment fund shareholder control role as fund promoter customers can redeem their claims at any time; and the absence of employees. These unique characteristics of investment fund governance cast doubt on the practical validity of some of the theoretical assumptions applied in prior empirical research on investment fund boards. These unique characteristics also provide an opportunity to add insights to our understanding of the role of a wide range of boards operating with limited power in practice.

In addition to theorising on "open" corporations, Fama and Jensen's (1983a) seminal paper theorises the separation of ownership and control at the level of financial mutuals, including investment funds. Fama and Jensen (1983a) differentiate the decision management roles of management, the decision control roles of boards of directors and the residual risk-bearing claimant roles of shareholders (illustrated on the left-hand side of Figure 1, for an "open" corporation). Unlike open corporations, shareholders in investment funds can redeem their claims at any time and as such are deemed to have a shareholder control role. Fama and Jensen (1983a) acknowledge this when they state that because of the strong decision control inherent in the redeemable residual claims of mutual fund shareholders, their boards are less important in the control process. Thus, Fama and Jensen (1983a) do not purport a decision control role for investment fund boards equivalent to the decision control role hypothesised for corporate boards. Rather they consider that the role of fund boards is limited to addressing agency problems not solved by the redeemable nature of claims of investors. This is where we pick up the story and challenge Fama and Jensen's (1983a) (albeit reduced) control-role theory of investment fund boards. While investment fund boards have been subject to empirical research, surprisingly, Fama and Jensen's (1983a) theorising on financial mutuals has not been developed, possibly because of taken-for-granted assumptions on the part of researchers who do not adequately differentiate between open corporations and financial mutuals.

As illustrated in Figure 1, Fama and Jensen (1983b, p. 337) comment "[…] mutuals exist side by side with open corporations". Thus, a fund promoter organisation will have its own "open corporation" board and in addition tens if not hundreds of investment fund boards operating alongside the fund promoter organisation's own board. This has implications for how investment fund boards operate. We question whether the assumption that investment fund boards have a (albeit reduced) control role is appropriate and whether the control role Fama and Jensen (1983a) ascribe to investment fund boards, which is different from open corporations, is appropriate. Rather than focusing solely on measurable variables, an understanding of the roles adopted by boards of directors in practice (Nicholson and Kiel, 2004) and the conditions under which they can execute these roles in practice (Roberts *et al*., 2005) is critical to evaluating investment fund (and other) board roles and board effectiveness. We have gone back to first principles to first identify the role of fund boards. Given the lack of understanding of how investment fund boards operate reflected in the prior literature, we develop a theory of the role of investment fund boards from the ground up using the voices of fund directors. We choose grounded theory methodology, the most widely used qualitative approach in the social sciences (Denzin and Lincoln, 1994), to develop theory.

3. Prior research

In this section, we examine prior empirical research on investment fund boards and the power relations around boards of directors.

3.1 Prior empirical research on investment fund boards

Prior empirical research on investment fund boards is largely quantitative, is USA based and has its roots in an agency theory perspective relevant to corporate boards with a focus on independent board structures and their effectiveness in executing certain board responsibilities under investment fund regulations. Prior research views proper functioning of independent non-executive directors as the key to effective fund governance. In addition, there are a number of discursive, non-empirical papers on the role of US investment fund boards (Ambler, 2005; Krug, 2013; Radin and Stevenson, 2006). Tufano and Sevick (1997) conceptualise the contribution of investment fund boards as equivalent to corporate boards, hence the focus on independent board structures. The board-related independent variables most prominent in the fund governance literature relate to board structure/composition and in particular: board size (Cremers *et al*., 2009; Del Guercio et al., 2003; Ferris and Yan, 2007; Khorana *et al*., 2007; Kong and Tang, 2008; Tufano and Sevick, 1997); board independence (Cremers *et al*., 2009; Del Guercio *et al*., 2003; Ding and Wermers, 2012; Ferris and Yan, 2007; Khorana, Tufano, and Wedge, 2007; Kong and Tang, 2008; Meschke, 2007; Tufano and Sevick, 1997); whether the chairperson is independent (Ding and Wermers, 2012; Ferris and Yan, 2007; Khorana *et al*., 2007; Kong and Tang, 2008; Meschke, 2007); the number of boards on which directors sit (board interlock) (Ferris and Yan, 2007; Kong and Tang, 2008); unitary boards (Ding and Wermers, 2012; Kong and Tang, 2008; Tufano and Sevick, 1997); independent director compensation and share ownership (Chen *et al*., 2008; Cremers *et al*., 2009; Del Guercio *et al*., 2003; Ferris and Yan, 2007; Khorana *et al*., 2007; Kong and Tang, 2008; Tufano and Sevick, 1997); the number of dealings non-executive directors have with fund advisors (Kuhnen, 2009); the existence of staggered boards (Del Guercio, Dann and Partch, 2003); and corporate governance indexes (Chen and Huang, 2011). Prior research does not adequately take account of their unique contextual features and unquestioningly transfers assumptions from corporate boards to investment fund boards. This has resulted in ambiguous empirical evidence on investment fund board effectiveness. We question the validity of these theoretical assumptions/variables applied in prior empirical research on investment fund boards. We believe this stream of research is erroneous as it is based on implicit and explicit assumptions that investment fund boards can exercise control roles.

3.2 Prior research on power relations and boards of directors

Merino *et al*. (2010, p. 777) observe that "the key to the corporate governance debate is, and always has been, power". Stein (2008) characterises regimes of corporate governance and reforms as highly complex and subjective systems influenced by power relations, which encompass the totality of individuals' relationships and interactions with one another. Echoing this sentiment, Sikka (2008, p. 956) states: "Corporate governance processes and policies are the outcome of politics that take account of particular histories, institutional structures and power relations", an observation mirrored by Spira and Page (2003, p. 641) when they quote Jackson (2000, p. 266): "Corporate governance reflects the power relations and political settlements between shareholders, creditors, management and labour as they are embodied in a particular institutional history."

Researchers have recognised the need to move beyond board structures by exploring behavioural perspectives of boards (e.g. Huse, 2005), board process, context and power (e.g. Pettigrew and McNulty, 1995, 1998; Pettigrew, 1997; Pye and Pettigrew, 2005). Indeed, in considering power relations at board level, Pettigrew and McNulty (1995, p. 871) argue that legal and regulatory discussion, with their focus on creating accountability, "do not always take place informed by the realities of boardroom power and influence." A central theme of Pettigrew and McNulty's (1995, 1998) conceptualisations is that agency theory is about power. They argue that the prominence of agency principles has elevated the control and monitoring roles of non-executive directors. Although recognising that the notion of power is not explicit in agency theory, they argue that boards need power to control and monitor management. Hendry *et al*. (2010, p. 43) define board power as "the board's ability to produce intended effects in line with its perceived interests, especially its ability to overcome management resistance in achieving its aims."

Commencing with the seminal work of Mace (1971), prior empirical research considers board-of-director power imbalances at an individual level between CEOs/management and boards (e.g. Pearce and Zahra, 2006). However, in our study, the power imbalances considered are structural rather than interpersonal. Pfeffer and Salancik's (1978) resource dependence theory primarily focuses on power at an organisational level. The central tenet of resource dependency theory is that the power one party can wield over the other depends on the relative importance of the resources each controls. If the resources of one party are essential to the other party, then this dependence puts the controlling party in a powerful position (Cool and Henderson, 1998, p. 911). This describes the power fund promoters can wield over investment fund boards. In relation to the large power differential between investment fund boards and fund promoters, we concur with Turley and Zaman's (2007) conclusions (in relation to audit committees but extendable to boards of directors) on the significance of power relationships in conditioning outcomes and that these factors need to be theorised, alongside more conventionally recognised factors.

4. Research methodology

We develop theory on the role of investment fund boards from the ground up, using grounded theory methodology, which we choose for three reasons:

(1) Grounded theory has an established reputation for the study of human behaviour and for making knowledge claims about how individuals interpret reality (Suddaby, 2006).

(2) Grounded theory has as its central aim the objective of theory building, rather than theory testing. It is an appropriate approach to use when existing theory does not fully explain a process (Creswell, 2007). Grounded theory facilitates the recording and interpretation of individuals' subjective experiences and enables the abstraction from this subjective experience into theoretical statements (Fendt and Sachs, 2008).

(3) Grounded theory has an established set of guidelines for conducting the research and interpreting the data, particularly the systematic approach of Corbin and Strauss (2008).

A stage-by-stage description of the methodology is summarised in Figure A1. It is beyond the length constraints of our paper to detail each individual step taken.[4] Grounded theory involves simultaneous collection and analysis of data. Data derived from interviews are analysed into distinct units of meaning which are labelled (coded) to generate concepts. Concepts vary in levels of abstraction. There are basic-level concepts and higher-level concepts that Corbin and Strauss (2008) call categories. Categories have wider explanatory power than concepts. As the research progresses, the concepts are re-evaluated for their interrelationships (Stage 4 in Figure A1). Through a series of analytical steps, the concepts are gradually assumed into higher-order categories, including one underlying central or core category. These higher-order categories and the central/core category suggest an emergent theory.

We initially sought research participants from amongst the pool of Irish resident non-executive directors of Irish domiciled fund boards. Ireland is the second largest European domicile for investment funds (European Fund and Asset Management Association, 2016). The Investment Directors Forum (IDF) was established in 2008 to represent the interests of Irish resident non-executive directors of investment funds. A list of the IDF membership comprising 41 members (all non-executive directors) was obtained as an ideal pool from which to select Irish resident non-executive director participants.[5] Prior to entering the field, the 41 non-executive directors were profiled. Participants were chosen because they had characteristics that enabled the core grounded-theory themes emerging from the data to be understood in greater detail. Prior to entering the field, we contacted prospective director participants by e-mail containing a very brief overview of the research and asking them to express an interest in participating in the research. We selected the 14 non-executive director participants (two of whom were interviewed twice) based on: their length of time acting as a fund director; the size of their director portfolio (in terms of number of directorships); the geographical spread of their director portfolio; the size of fund promoter organisations comprising their directors' portfolio; prior fund industry experience (operational vs compliance vs legal backgrounds); and their exposure to non-Irish funds. As the interview process progressed, the benefit and need to discuss emerging themes with fund-promoter executive directors became apparent. We obtained access to seven fund-promoter executive directors across six large fund promoter organisations in Stages 2 and 3. We conducted twenty-five semi-structured interviews: Sixteen interviews with 14 non-executive directors and nine with seven fund-promoter executive directors of investment fund boards. The interviews tapped into over 100 investment funds, as each director has a portfolio of directorships. Typically in the investment fund industry, directors serve on multiple boards (Tufano and Sevick, 1997). In the USA, non-executive directors tend to sit on boards of a single fund promoter organisation; in Europe, they tend to sit on boards across a number of fund promoter organisations.

The study is located in Ireland which is representative of the jurisdictions in which mutual funds operate. Regulatory differences in Ireland vs other jurisdictions do not affect the applicability of the findings to investment fund boards in other countries. Table I profiles the research participants and summarises the interviews conducted. Participant characteristics relevant to the research – number of fund directorships held[6], years' director experience and jurisdictional exposure of directors/their funds – are included. In order to protect their identity, we do not reveal more personal director characteristics such as age, gender and professional background.

Table I. Profile of Research Participants and Characteristics of Interviews Conducted

Panel A: Non-executive directors (NEDs)

Interview	Research Participant	Number of Directorships	Geographical Exposure to Fund Promoter Organisations	Directors' Experience (Years)	Length of Interview	No. Pages	No. Words
INT 01[1]	NED 01	<20	Europe	<5	1 hour 21 minutes	28	9,531
INT 02[1]	NED 02	>20	Europe	>5	1 hour 32 minutes	33	12,905
INT 03[1]	NED 03	<20	Europe	<5	1 hour 26 minutes	34	11,800
INT 04[1]	NED 04	>20	US and Europe	<5	2 hours 05 minutes	44	19,356
INT 05[1]	NED 05	>20	US and Europe	>5	1 hour 02 minutes	28	8,620
INT 06[1]	NED 06	<20	Europe	<5	1 hour 40 minutes	35	9,263
INT 07[1]	NED 07	>20	Europe	<5	1 hour 12 minutes	40	10,224
INT 08[1]	NED 08	>20	US and Europe	>5	1 hour 12 minutes	44	12,932
INT 09[1]	NED 09	>20	US and Europe	>5	54 minutes	26	6,442
INT 10[1]	NED 10	<20	Europe	<5	1 hour 06 minutes	32	9,038
INT 11[1]	NED 11	>20	US and Europe	>5	1 hour 05 minutes	42	12,795
INT 12[1]	NED 12	>20	US and Europe	>5	1 hour 03 minutes	42	11,904
INT 13[1]	NED 13	>20	US and Europe	>5	50 minutes	29	8,548
INT 21[2]	NED 14	<20	UK	<5	1 hour 03 minutes	4	1,404
INT 22[2,3]	NED 04				57 minutes	4	1,513
INT 23[2,3]	NED 05				28 minutes	2	824

Panel B: Fund-promoter executive directors (FPEDs)

Interview	Research Participant	Origin of Fund Promoter Organisation	Level of Seniority in Organisation	Length of Interview	No. Pages	No. Words
INT 14[1]	FPED 01	US	Director	1 hour 06 minutes	32	9,691
INT 15[1]	FPED 02	Europe	Director	1 hour 16 minutes	41	12,604
INT 16[1]	FPED 03	Europe	Director	1 hour 17 minutes	45	14,392
INT 17[1]	FPED 04	Europe	Director	50 minutes	22	8,152
INT 18[1]	FPED 05	US	Director	46 minutes	23	7,921
INT 19[1]	FPED 06	Europe	Senior Executive	36 minutes	23	5,943
INT 20[1]	FPED 07	US	Director	1 hour 03 minutes	26	8,555
INT 24[2,3]	FPED 02			22 minutes	1	255
INT 25[2,3]	FPED 05			24 minutes	1	271
	Total			**26 hours 36 minutes**	**681**	**214,883**

[1] Interviews 1 to 20 conducted April 2009-May 2010
[2] Interviews 21 to 25 conducted May 2010
[3] Transcripts from interviews 22 to 25 (field research 2) were not transcribed in full. Length of transcript reflects amount of data (in pages) transcribed from the interview tape.

One of the authors of the paper conducted the interviews, generally in the participants' own offices. Interviews were tape recorded and the transcripts were analysed following grounded theory methods. Once a preliminary theoretical framework had been constructed from the data, one focus group session was held with four non-executive directors and two fund-promoter executive directors who had participated in the research. The purpose of the focus group was to assess whether the theory generated by researchers from the grounded theory methodology accurately reflected the voices on the ground and resonated with participants. The focus group session lasted six hours and generated 149 pages of data (47,433 words) and assisted in finalising the theoretical framework.

We present the theoretical framework generated from the grounded theory methodology in the next section, supported by illustrative quotes from the on-the-ground voices of participants in the research.

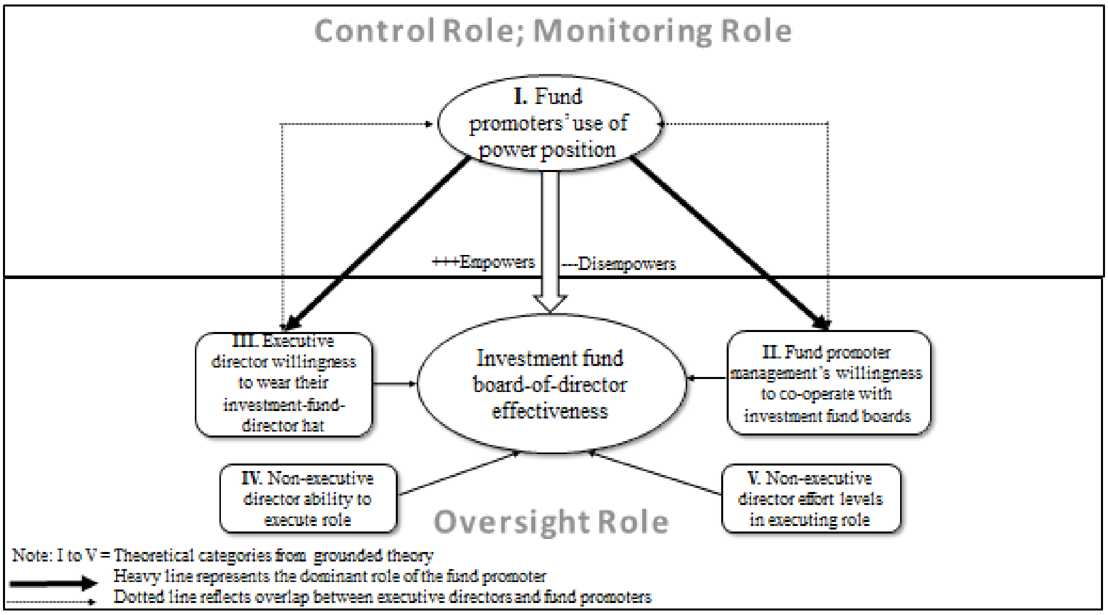
5. Findings

What emerged from the grounded theory analysis is that fund boards of directors cannot be considered in isolation from other elements of the overall governance framework for investment funds – notably from investors and most importantly from the fund promoter.

Thus, the investment funds governance framework is made up of three key interrelated elements: first, fund promoter organisations' internal governance framework, used to execute their control and monitoring roles. Fama and Jensen (1983b, p. 337) hinted at this with their observation that mutuals exist side-by-side with open corporations; second investment fund investors; and third investment fund boards comprising non-executive and fund-promoter executive directors.

Five higher-order theoretical categories (identified by the symbols I to V in Figure 2) were developed from the grounded theory research (Stage 4, Figure A1) leading to an emergent theory. Our theoretical framework has fund promoter organisations' use of their power position at its core (see Figure 2). Our central/core higher-order theoretical category dominates the other four higher-order theoretical categories. Overlaid on the five higher-order theoretical categories are the three key roles: control, monitoring and oversight roles. Section 5.1 discusses the central role of the fund promoter (Theoretical category I) and the related roles of fund promoter executive directors (Theoretical categories II and III).[7] Section 5.2 discusses the three key roles, while Section 5.3 draws the discussion together and considers its theoretical significant for investment fund boards.

Figure 2: Theory of Investment Fund Board Roles and Effectiveness



5.1 Central role and power of fund promoter organisations

The central theoretical category (theoretical category I in Figure 2) constructed from the grounded theory methodology was found to be fund promoter organisations' use of their power position. This is consistent with Figure 1, which highlights fund promoter organisations' control over the fund product, launching it and preparing the accompanying marketing document (e.g. prospectus or pitch book), and over all third-party service provider appointments to the fund. Fund promoter organisations' use of their power position can empower or disempower fund boards, depending on fund promoter organisations' willingness to co-operate with them (see Figure 2).

<u>Fund Promoter Organisations' Use of their Power Position</u>

Actions taken by fund promoter organisations reflect the use by fund promoter organisations of their power position. Consequently, much of non-executive directors' ability to execute their role is framed by the perceptions and actions of fund promoter organisations. Effective fund boards successfully merge internal (fund promoter organisations' internal governance frameworks) and external (non-executive directors) governance elements. Thus, non-executive directors cannot address the agency problem for investment funds unless fund promoters want them to. This is because the fund promoter holds the balance of power. Fund promoters are uniquely placed in the context of investment fund governance. While *de jure* investors invest in funds governed by a board of directors, they are *de facto* investing in fund promoters' brands. It is fund promoters' reputation that attracts investors and underpins the relationship between the two. Fund promoters make the key strategic decisions relating to funds consistent with fund promoters' overall corporate strategy. These decisions are brought to fund boards solely for ratification purposes. The investment management function, the principal income-generating activity of funds, is generally outsourced to a division within fund promoter organisations. This relationship impacts on non-executive directors' oversight of the investment management function which, for many participants, is viewed as fund promoter territory. Fund promoters generally have global relationships with third party service providers selected to carry out functions on behalf of their funds. Fund promoters generally invest in internal governance frameworks to monitor all outsourced functions. Their internal governance framework is critical to fund board effectiveness.

Positive and effective governance can exist with or without investment fund boards of directors, provided the governance culture within fund promoter organisations is right. In such organisations, the interests of investors are paramount, and all actions taken reflect this ethos. Fund promoter organisations' position of power, and the implications for investment fund boards of fund promoter organisations' use of their power, is captured in Illustrative quote 1:

> Illustrative quote 1: Fund promoters' power
> "The non-executive directors obviously rely to a large extent in exercising that role on the information provided to them by the people they are overseeing. In that way it's similar to corporate governance. The difference is that in a corporate, the board is viewed as the apex of the organisation. I might work for the CEO but the board hire and fire him, let's face it. In a fund context it's different. The fund promoter organisation is inextricably linked to the fund and everyone will have a huge loyalty to that organisation. It would take a strong NED to oust a fund promoter from having a connection with its own product so you know it just wouldn't happen, it can't happen. So the dynamics are hugely different when you think of funds versus companies. It's like, you know if I wanted to draw a comparison, it's like an individual, or the CEO, wielding power on company boards versus an entire organisation, the fund promoter, wielding power in, sorry on, fund boards." (Source: Non-executive Director)

Fund promoter organisations control the selection of fund-promoter executive directors. Much of fund-promoter executive directors' ability to "wear their directors' hat"[8] (theoretical category III in Figure 2), therefore, is contingent on fund promoter organisations' use of their power position in the context of director selection/board composition. Fund-promoter executive directors must understand their role and respect the external governance mechanism (non-executive directors). Fund promoter organisations control the process of selecting the individuals capable of meeting these expectations. Research participants strongly suggested that having senior fund promoter representatives on fund boards creates greater accountability in the boardroom as shown in Illustrative quote 2:

> Illustrative quote 2: Importance of fund promoter executive directors
> "The most effective boards comprise senior fund promoter executives. If they question fund underperformance, the investment manager does not bombard them with complex jargon. He provides an explanation and a course of corrective action. It's like as though the pecking order in the fund promoter organisation is brought into the boardroom – there is clear accountability. The same goes for third party service providers. They might have a global relationship with the fund promoter and by God do they listen to issues raised by senior figures on the board. They don't want to jeopardise this global relationships. NEDs just don't have that type of power. No doubt a similar role can be played outside the boardroom but seeing the accountability in action provides me with significant comfort as a non-executive director. I can ask questions of fund promoter and third party service providers knowing the questions will be answered 'cos of the guys sitting to my left." (Source: Non-executive Director)

Illustrative quote 3 shows how the knowledge capital is significantly improved by senior fund promoter organisation executive representation on fund boards. They bring an understanding of fund promoter organisations' overall strategy, yet are accountable in the boardroom for individual funds:

Illustrative quote 3: Information role of fund promoter executive directors

"You know obviously I think it's, well I'm very interested to hear, you know, those particular roles designated that have to be fulfilled by people from the promoter but in fulfilling those roles they have statutory responsibilities and exposures and then they have to act when they're fulfilling those roles in the best interest of the fund board and report to the fund board when they've got that hat on and some of them are employed by the promoter but they don't have an executive role within the promoter so the CFO or the CE, or the COO I think it is and the CCO, the chief compliance officer, you know, they are, maybe, employed, they're paid by the promoter but they actually, it might be their exclusive job to be a CCO to the various funds boards that the promoter has which I think is best of both worlds because you have the board who has the expertise from these people. They have, they don't have this, you know, conflict of interest and yet they are very experienced, very expert in their particular field which is where the non-executive directors don't really have that information, knowledge and time to do all that sort of research. So I think that sounds like to me a very optimal structure but expensive." (Source: Focus Group Participant)

Non-executive directors rely on the assistance of fund promoter organisations in their interactions with third party service providers. This reliance is reflected in the extent to which non-executive directors utilise fund promoter organisations' internal governance framework. Further, as fund promoter organisations select third party service providers, they can assist fund boards (who contract with these service providers on behalf of the fund) in engaging with third party service providers on important issues. Fund promoter organisations, in turn, have a vested interest in controlling and monitoring third party service providers. As a result, third party service providers are generally willing to engage and co-operate with fund boards.

A strong governance culture within fund promoter organisations does not necessarily equate to an effective investment fund board. Even where fund promoter organisations have a strong governance culture, they might not value the contribution of non-executive directors on fund boards. They might consider that their own internal governance framework is sufficiently robust, negating the need for an extra layer of governance. This perception is further exacerbated by weak non-executive directors and/or non-executive directors who seek to play a more executive role. In this situation, fund promoter organisations might view the board as nothing more than a regulatory conformance requirement. As discussed in Illustrative quote 4, arising from the power imbalance that is skewed in favour of fund promoter executive directors, very committed non-executive directors can find themselves on boards where their fund promoter co-directors want them to play a passive role. The unique characteristics of funds exacerbate the ability of fund promoter executive directors to put barriers in the way of non-executive directors' ability to execute their role, should fund promoters wish to.

Illustrative quote 4: Influence of fund promoters on role execution

"Occasionally you may come across a fund promoter who doesn't or a fund manager who really doesn't want the board to do anything than is more than absolutely necessary […] One thing I do know is that there is a big difference I think between US fund managers and European, particularly UK fund managers. I think the European experience or the UK experience with fund boards has been much more interactive. There's an expectation and I suppose understanding that fund boards will do more and want to do more if they get the opportunity. In many cases, I think the US managers […] expect the fund directors to, you know, to really turn up at the board meetings and not really do anything more than that. Well, you know, they will say yes well of course we will give you the information and you will ask the right questions but they really don't want the board to get involved." (Source: Non-executive Director)

Other fund promoter organisations, although acknowledging their own internal governance framework, value the role of boards of investment funds. For boards to be effective, fund promoter organisations must value the role boards play in the overall governance of investment funds and must empower those boards to execute their roles in a substantive and not just a ceremonial manner.

Fund Promoter Management's Willingness to Co-Operate with Fund Boards

Fund promoter management's (i.e., fund promoter organisation employees that provide services to the fund, typically the investment manager) willingness to co-operate with fund boards and to use their power positions positively is critical (theoretical category II in Figure 2). Fund promoter management is also fundamental to investment fund board roles. Boards are empowered where management is willing to co-operate with them.

Non-executive directors' role in relation to fund promoter management is more complicated arising from fund promoter managers being ultimately employed by fund promoter organisations. Investment managers can feel more accountable to their employer, the fund promoter organisation, than to the investment fund board that has contracted with their employer to provide investment management services. The ability of non-executive directors to execute their role is contingent on the willingness of fund promoter management to co-operate with fund boards. As for all board types, their effectiveness is also contingent on their own abilities (theoretical category IV in Figure 2) and effort levels (theoretical category V in Figure 2) in executing their role.

5.2 Oversight role of investment fund boards

Fund promoter organisations have a control role in relation to their investment products, which role is executed through their internal governance framework. As investment funds are products of fund promoter organisations, general strategic decisions for funds are also made within fund promoter organisations as part of the overall strategic decision-making process. Investment strategy decisions are taken by investment managers or advisors who are generally a division within fund promoter organisations. It could therefore be argued that fund promoter organisations control these decisions. As well as controlling key decisions relating to their investment funds (control role), fund promoters monitor the on-going activities of those responsible for the day-to-day management of their funds (monitoring role), intensively using performance management systems and incentive mechanisms.

Except for a small minority of non-executive directors who believe they make a strategic contribution, the majority of non-executive director participants were adamant that non-executive directors do not play a strategic participatory role within investment fund boards, a sentiment shared by their fund-promoter executive director colleagues whose role it is to bring fund promoter strategy into fund boardrooms (see Illustrative quotes 5-7).

> Illustrative quote 5: Absence of strategic participatory role for non-executive directors
> "Plc directors are very much, it isn't just compliance or corporate governance. The non-executive director probably has more of a say in the strategy of the company and the fund boards are a bit different. Now this is my experience of them and I'm no expert when it comes to plcs but I think the plc non-executive directors have more of a strategy role. And executives must deliver that but in funds, directors I think the role is a bit different. It's more of an oversight compliance audit role. A watchdog." (Source: Non-executive Director).
>
> Illustrative quote 6: Fund promoters drive strategy
> "[…] again my feeling is that the board of directors of the fund aren't the primary drivers of the strategy basically. I would see that as the fund promoter basically." (Source: Fund-promoter executive Director)
>
> Illustrative quote 7: Fund promoters make strategic decisions
> "It will be the promoter that makes the decision so I mean rationalisations … should be in the interest of the shareholders as well […] Generally if there's a view taken to merge or liquidate a fund, you'll see it's possibly down to poor performance, not gathering assets. It doesn't have a future, its expense ratio is possibly climbing […] So essentially those decisions are essentially made outside the boardroom, brought into the boardroom for ratification." (Source: Fund-promoter executive Director)

Non-executive directors of investment fund boards interpret their primary role as one of oversight. This is contrary to Fama and Jensen's (1983a) theorising. While Fama and Jensen (1983a) acknowledge that fund boards' control role is less than for open corporations, our research finds that investment fund boards do not have a control role. Fama and Jensen's (1983a) lesser control role for investment fund boards arises because of the shareholder control role in investment funds arising from their ability to redeem their claims at any time.

Fama and Jensen (1983a) do not refer to the central role of fund promoter organisations. This could partly be due to what they exclude from their concept of control, and partly to their focus being on the relationship between ownership and control. Because of the fund promoter's central role, investment fund board of directors' role is relegated to one of oversight, not control.

Oversight emerged from the grounded theory research as the primary role of investment fund boards, as did the distinction between the role of oversight vs control and monitoring. Figure 3 distinguishes between the three concepts of control, monitoring and oversight in the context of investment funds. The characteristics are based on our interpretation of the differences in the three roles from the research.

Figure 2 shows the fund promoter organisation as dominant, exercising control and monitoring roles in the top half of the diagram, and the investment fund board exercising oversight in the bottom half. The findings in Figure 2 reflect the practical rather than the legal definitions or empirical interpretations of oversight vs control vs monitoring roles.

Minimal variance was identified across research participants (fund-promoter executive and non-executive directors) regarding the roles that fund-promoter executive and non-executive directors play. There is general consensus that the oversight role has primacy in board process and that the role is a collective board role, not just the responsibility of non-executive directors. The oversight role was consistently cited by participants when questioned about the role of fund boards , for example, as in Illustrative quote 8:

> Illustrative quote 8: Oversight, not control role (1)
> "The role of the board is not control. It's oversight; it cannot be control. It's oversight and review." (Source: Non-executive Director)

The term "control" suggests a level of influence on management not reflected in the term "oversight." Significantly, none of the participants (fund-promoter executive or non-executive directors) used the term "control" to describe their role. The significance of this distinction became more apparent during the course of the interview process where a greater appreciation of the implications of the unique characteristics of investment funds was obtained. Drawing on this distinction between the terms "control" and "oversight", we asked several non-executive directors why the term "oversight" was used to describe their role rather than control. The non-executive director in Illustrative quote 9 interprets the outsourcing model that characterises the funds industry, using the term "virtual entity" to describe funds.

> Illustrative quote 9: Oversight, not control role (2)
> "I don't like the term control as it suggests we have more power than we do. I cannot walk into one location and speak to the main people working on my funds. They are dispersed, even geographically – delegated to specialists. A fund is almost like a virtual entity, although ironically it is very complex. So no; the role is to look after shareholders' interests through oversight. It's not realistic to call it control. I oversee to make sure the specialists are doing their job within the rules. I monitor to make sure the specialists are doing their job within the rules." (Source: Non-executive Director)

Even where fund-promoter executive directors are involved in the day-to-day management of funds, no one director has overall responsibility for all the activities of funds, in contrast to the position of CEO within a corporation. The sentiment expressed by the non-executive director in Illustrative quote 9 is that, with the core management functions outsourced to those who have the expertise to carry out those functions, the primary role of boards becomes one of oversight of outsourced functions rather than control of the key activities. The non-executive director in Illustrative quote 10, while highlighting the absence of strategic involvement by non-executive directors, further demonstrates the distinction between oversight and control:

Illustrative quote 10: Oversight, not control role (3)

"Control? I wouldn't use that word. It isn't a corporate. I have so little input into strategic matters so I can't really control that. I'd say oversight is a better description. We oversee delegated activities. I oversee what the investment manager is doing is consistent with what the prospectus says. We never get involved in the nitty gritty of things, which I think the term control suggests." (Source: Non-executive Director)

While the interviewee in Illustrative Quote 10 adamantly uses the term "oversight", the interviewee in Illustrative Quote 9 uses both terms "monitor" and "oversight" when speaking about his roles. Related words used by interviewees include "review" (Illustrative Quote 8) and "ratification" (Illustrative Quote 7). Thus, in practice, there is a blurring between monitoring and oversight roles, but not between control and monitoring and/or oversight.

Non-executive directors' reliance on fund promoters' internal governance framework can be traced to the dispersed nature of investment fund activities/management arising from the outsourcing model. Illustrative quote 11 reflects the importance of fund promoters' infrastructure in enabling fund boards oversee "outsourced" functions.

Illustrative quote 11: Reliance on fund promoter to exercise oversight

"The outsource model where everything is completely outsourced doesn't work unless the promoter devotes resources to it as well […] the model is somewhat lacking, so for example you know the board has to get support from the promoter in a lot of areas some of which are say their compliance team, their internal audit team, their tax team, their credit review team […] If you didn't have the promoter willing to do all of that, it creates a difficulty." (Source: Non-executive Director)

Differentiating control, monitoring and oversight

Given the unexpected finding that investment fund boards can only exercise oversight rather than control and/or monitoring roles (reflected in illustrative quotes 8 to 11), it is necessary to understand the distinction between these roles. We briefly review how the terms "control", "monitoring" and "oversight" have been used in prior research. Illustrating the difficulty in defining the terms, Tosi and Gomez-Mejia (1989, p. 183) comment that agency theory's key concept, monitoring, is definitionally complex and that the levels and effects of monitoring vary by ownership structure. They argue that it may be possible to unravel its underlying substructure and evaluate the relative effects of different dimensions.

In differentiating between the three roles, our analysis is informed by the summary definitions in Table II which reproduces a selection of definitions of control, monitoring and oversight used in the prior corporate and boards of directors' literature. These definitions are quite generic and are not context specific. Herman (1981) takes the most in-depth consideration of the concept of control in a corporate context. He identifies the board of directors as the immediate and legal locus of control. In elaborating on his definition of control, Herman (1981) distinguishes between "literal control" and the "power to constrain".

Table II. Control, monitoring, oversight definitions in the prior literature

Definitions of control	
①	"[…] the capacity to initiate, constrain, circumscribe, or terminate action, either directly or by influence exercised on those with immediate decision-making authority." (Herman, 1981, p. 17).
②	"[…] *literal control* [emphasis in the original]… means the power to make the key decisions of a company, which include choices of products, major markets, volume and direction of investment […] and selection of top personnel." (Herman, 1981, p. 19).
③	"The *power to constrain* [emphasis in the original] is used to mean the power to limit certain decision choices, as in […] a power of veto over personnel choices." (Herman, 1981, p. 19).
④	"[…] the rights to ratify and monitor major policy initiatives and to hire, fire and set the compensation of top level decision managers." (Fama and Jensen, 1983a, p. 313).
Definitions of monitoring	
⑤	"As it is used in this paper the term monitoring includes more than just measuring or observing the behavior of the agent. It includes efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules, etc." (Jensen and Meckling 1976, p. 308, Footnote 9)
⑥	"[…] monitoring is defined as observation of an agent's effort or outcomes that is accomplished through supervision, accounting controls and other devices (Jensen and Meckling 1976)." (Tosi *et al.*,1997, p. 588)
⑦	"[…] monitoring is defined as the direct or indirect observation of the agent's effort, or behavior, over some period of time (Jensen and Meckling, 1976; Singh, 1985). It can be achieved through budgets, responsibility accounting, rules, and policies." (Tosi and Gomez-Mejia, 1989, p. 171)
⑧	"We define monitoring as any collection of information by the principal in this agency relationship, whether for supporting direct incentives or for setting limits on employees' behaviors." (Jacobides and Croson, 2001, p. 203)
⑨	"I define monitoring as the activities of the board and its individual directors that track the significant behaviors of executives, the outcomes of their actions, and the performance of the venture in order to ensure that corrective action is taken as needed." (Garg, 2013, p. 90)
Definitions of oversight	
⑩	"[…] oversight means overseeing or monitoring others' activities and not doing things directly." (Kanda, 2000, p. 7)
⑪	"Oversight means the board must also control major compensation issues." (Ide, 2003, p. 837)

There are four key takeaways from the summary in Table II:
(1) Some definitions use the three terms interchangeably (e.g. definitions ④, ⑩ and ⑪).
(2) The definitions reveal that interpretation of the terms "control", "monitoring" and "oversight" varies. For example, is monitoring "observation" (e.g. Definition ⑤ and ⑥) or does it involve "corrective action" (e.g. Definition ⑨) as well? Does oversight involve control over compensation (e.g. Definition ⑪)?
(3) Some definitions distinguish between direct (e.g. Definition ①, ⑦) and indirect (e.g. Definition ⑦, ⑩) action.
(4) Three of the definitions use the word "observation" (Definition ⑤, ⑥ and ⑦).

Fama and Jensen's (1983a, p. 313) definition (Definition ④ in Table II) and Herman's (1981) definitions of control either specify action or imply it (Definitions ①, ② and ③ in Table II). Thus, control roles imply direct action, direct consequences in the power to determine broad policies guiding organisation and management, actual decision-making power, the ability to hire and fire key personnel and establishment of the parameters within which management can operate. Mizruchi (1983, p. 429) uses a similar definition of control, and adds "The width of these boundaries [within which managerial decision making will occur] will vary among different corporations".

Table III summarises the roles assumed/expected of investment fund boards in prior research. These extracts demonstrate the confusion in the prior literature, with most authors using two or three terms, not one term, to describe investment fund board roles. Radin and Stevenson (2006)(⑤ in Table III) is one of the few studies to acknowledge that investment fund boards do not have a control role.

Table III. Roles of investment fund boards assumed in the prior literature

① "[…] the top-level decision control device in financial mutuals is a board of directors. Because of the strong form of diffuse decision control inherent in the redeemable residual claims of financial mutuals, however, their boards are less important in the control process than the boards of open nonfinancial corporations." (Fama and Jensen 1983a, p. 318)

② "[…] each mutual fund be overseen by a board of directors […] Funds or fund sponsors … would be more likely to select boards that would be less effective monitors." (Tufano and Sevick, 1997, p. 324; 327)

③ "[…] boards of closed-end funds have responsibilities limited to monitoring." (Del Guercio *et al*., 2003, p. 112)

④ "[…] we consider the following control mechanisms as alternatives to explicit investment restrictions: (i) direct monitoring and the role of fund directors […] the board of directors of a fund must oversee the fund's operations … directors must monitor the fund to verify compliance with stated investment policies and restrictions […]" (Almazan *et al*., 2004, p. 290; 301)

⑤ "The reason why independent directors do not have full control […] Each board should ensure that among its ranks are members with the skills required to oversee and monitor the complexities of its funds." (Radin and Stevenson, 2006, p. 370; 374)

⑥ "[…] it might be that board oversight is more valuable for funds with poor performance … monitoring by mutual fund boards on behalf of fund shareholders" (Ferris and Yan 2007, p. 415; 417)

⑦ "Each fund is overseen by a board of directors […] Board members with a higher level of expertise might be more effective monitors." (Khorana *et al*., 2007, p. 573; 583)

⑧ "[…] A mutual fund is overseen by a board of directors […] Requiring mutual funds to be monitored by boards…" (Meschke, 2007, p. 5; 7)

⑨ "the main role of mutual fund directors is to monitor […] in funds they oversee when the benefit from monitoring is expected to be higher, and when there is a lack of other control mechanisms." (Chen *et al*., 2008, p. 2630, 2675)

⑩ "[…] one board overseeing all funds in the entire family […] the monitoring role of independent directors, who act as sole fiduciaries to the shareholders of the fund" (Kong and Tang, 2008, p. 193; 197)

⑪ "[…] directors have the important monitoring role of resolving a wide array of conflicts of interests between the advisory firm and the fund's shareholders." (Cremers *et al*., 2009, p. 1368)

⑫ "A second strand of the corporate governance literature focuses on the effectiveness of the board, as manager incentive alignment and effective board monitoring" (Chen and Huang, 2011, p. 313)

⑬ "However, fund directors monitor the investment performance of the funds that they oversee (often using consultants) as the primary indicator of output quality of the fund—which is then used as the main determinant of retaining or firing the management company, as well as (jointly) negotiating the fee upward or downward" (Ding and Wermers, 2012, p. 6)

Control, monitoring and oversight keywords underlined

The terms "monitoring" and "oversight" are often used interchangeably. We distinguish the two constructs by virtue of the level at which each is applied. On the basis that Jensen and Meckling (1976, p. 308, footnote 9) refer to monitoring in terms of "observing the behavior of the agent", we consider monitoring to involve direct review/observation of management performance, *inter alia*, through on-going performance management assessments (e.g. of fund promoter employees by fund promoter managers) and service level assessments (of third party providers). Monitoring may be accompanied by consequences for employees who do not perform adequately, in other words, the exercise of control. Monitoring must precede control, but monitoring may occur on its own without subsequent control actions. If there are consequences following monitoring, they can be so minor as to not amount to control.

We characterise oversight as "keeping a watchful eye" acting on behalf of shareholders' interests particularly in relation to the parameters within which fund managers can operate and taking particular account of conflicts of interests between fund promoters and investors. Oversight, a weaker term than monitoring, reflects the unique features of investment fund companies as virtual entities with no employees. Oversight is therefore indirect. In the context of financial statement fraud, Rezaee (2005) distinguishes between direct and indirect monitoring, whereas Tosi and Gomez-Mejia. (1989, p.171) define monitoring as "direct and indirect observation" (definition ⑦ in Table II). Our definitions differentiate between direct and indirect observation. Those exercising oversight cannot take direct action. They can only obtain consequences through another party, in this instance, the fund promoter organisation. Oversight is not an extra layer of control. It is an extra layer of indirect monitoring. The word "oversight" is frequently used to describe the work of audit committees. They are an extra pair of eyes and ears for corporate boards. Our distinction between direct monitoring and indirect oversight depends on the "degree of observability" (Arnott and Stiglitz, 1991, p. 188). Direct monitoring implies a degree of proximity to those being monitored, an ability of principals to monitor agents themselves (Arnott and Stiglitz, 1991, p. 180) and an ability to establish and implement direct performance management and/or service level processes. For example, traditional boards receive presentations from the CEO and senior managers and can thus directly monitor, face-to-face, their performance. This is not possible in investment fund boards as investment funds have no direct employees. Indirect oversight, in contrast, implies overseeing the mechanism or construct without the powers of direct observation, arising from observability at a distance and lack of proximity (investment funds have no employees) or the ability to take direct action. Illustrative quote 9 captures this constraint well.

We summarise our differentiation between the three terms in Figure 3, distinguishing between no action and direct action and direct and indirect observation. We complete the fourth quadrant in Figure 3 by adding shareholder activism. Shareholders indirectly observe management and may take direct action as a result. For example, in an investment fund context, shareholders may redeem their claims. In a corporate context, shareholders may vote against a resolution (e.g. CEO pay in a say-on-pay resolution) at an annual general meeting. For each of the three terms, there is a continuum of behaviours, from highly proactive directors to "spectator" directors, depending on effort levels expended by directors in executing their roles (Theoretical category V in Figure 2).

Figure 3. Differentiating control, monitoring and oversight

	No action		Direct action
Direct observation	Monitoring	→	Control
Indirect observation	Oversight	→	Shareholder activism

Direct observation: Ability of principals to monitor agents themselves, by virtue of the degree of observability and degree of proximity of principals and agents

Indirect observation: Overseeing the mechanism or construct without the powers of direct observation

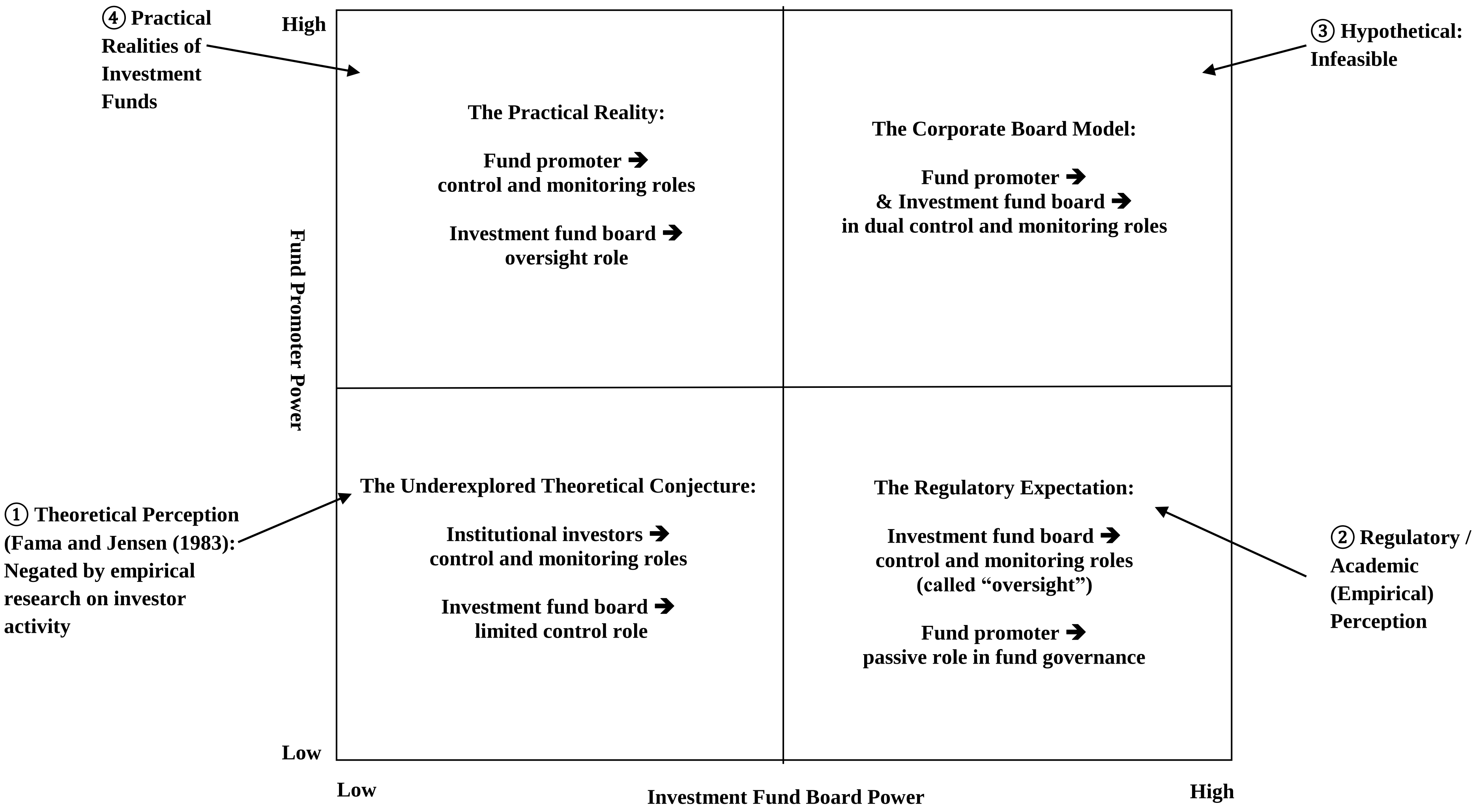
→ Control/shareholder activism will always be preceded by monitoring/oversight. Control/shareholder activism will not necessarily follow monitoring/oversight.

Fund promoter organisations appoint their own representatives to fund boards (fund-promoter executive directors). Fund-promoter executive directors share the oversight role with non-executive directors. Much of their execution of these roles is carried out as part of the internal governance framework within their employers, the fund promoter organisations. To be more precise, although control and monitoring are carried on within fund promoter organisations, fund-promoter executive directors of investment funds may or may not be directly involved in these roles depending on their position and seniority within fund promoter organisations. Fund-promoter executive directors are part (directly or otherwise) of the framework outside fund boardrooms that carry out the control and monitoring roles. The same is true of fund promoter organisations' strategic role.

5.3 Control versus oversight: theoretical significance for investment fund governance

Fama and Jensen (1983a) do not purport a decision control role for investment fund boards equivalent to the decision control role hypothesised for corporate boards. Rather they consider that the role of fund boards is limited to addressing agency problems not solved by the redeemable nature of claims of investors. Our research has found that the primary role of investment fund boards is less significant than the decision control role of corporate boards due to fund promoter organisation contextual factors, rather than the power (or control role) of investors conceptualised by Fama and Jensen (1983a). The oversight role enacted by investment fund boards in practice is influenced by the control and monitoring roles that fund promoter organisations assume by virtue of their position as investment fund product producers. Investment fund boards can, at best, execute an oversight role because anything more than this is encroaching on the role that fund promoter organisations execute as product producers (their control and monitoring roles). Fund promoter organisations' ability to ensure that their control and monitoring roles dominate the investment governance framework can be linked to their unique position of power. The influence of fund promoter organisations' power position on the respective roles of fund promoter organisations and investment fund boards is captured in Figure 2. The implications of our theoretical framework in Figure 2 lead us to set out four typologies of governance structure in Figure 4, capturing regulatory, theoretical and empirical conceptualisations of fund boards, as well as how boards operate in practice. In our opinion, only one of the four typologies (Quadrant ④) reflects the reality of fund boards, the other three being hypothetical/not applicable in practice (Quadrants ①, ② and ③).

Figure 4.
Influence of Fund Promoter Power on Control versus Monitoring versus Oversight Roles of Fund Boards and Fund Promoters



The underexplored theoretical conjecture

Quadrant ① of Figure 4 captures Fama and Jensen’s (1983a) seminal theorising on mutual funds. The separation of decision management from residual risk bearing arising from the investor/management relationship necessitates a form of decision control. Boards are considered less relevant in this space where the ability of investors to veto fund promoter decisions and redeem their investment on demand demotes boards’ role to managing agency problems not solved in the market for fund shares. Fama and Jensen (1983a) do not conceptualise the conditions under which fund boards’ role is enacted. Thus, the role of fund boards in practice must be broader than the role envisaged by Fama and Jensen (1983a), underexplored as it was.

The regulatory expectation

Although regulators, in the USA in particular, and empirical researchers exploring fund boards use terms such as “oversight” and “monitoring” to describe their role, these terms do not really capture regulators’ and researchers’ expectations of these boards. US regulators, for example, require fund boards to strenuously negotiate fund-related fees and approve investment managers’ contracts on an annual basis, thus implying a more significant role than the term “oversight” suggests (Radin and Stevenson, 2006). Prior US-orientated empirical research has explored the extent to which fund boards have fulfilled regulatory expectations. The model of boards portrayed within the US regulatory framework and by empirical researchers is of boards with significant decision-making power. This is reflected in Quadrant ② of Figure 4.

The corporate model

Quadrant ③ in Figure 4 captures a hypothetical construct where fund promoter organisations and fund boards work together in a dual control and monitoring roles, with both parties having equivalent powers of decision making and influence. This reflects the corporate model of fund boards where non-executive directors, the fund-promoter CEO and fund-promoter executive directors collectively approve broad policies guiding organisation and management, have matters reserved for their decision, agree the management construct – the parameters within which management can operate – and put mechanisms in place to monitor it. In a company, strategy is decided by the board; for funds, by the fund promoter. The fund promoter organisation acts *in loco* the CEO in an investment fund context. We interpret this model to be infeasible in a fund context.

The practical reality

Quadrant ④ in Figure 4 reflects the practical realities of investment fund governance. Fund promoters determine the broad policies of their own products in line with their overall organisational strategy. They are the decision makers on whether a fund will be wound up, whether fees will increase or decrease, whether a fund will merge with another fund, on the appointment and termination of service provider contracts. Boards ratify these decisions. Consequently, fund promoters’ power is almost a latent process in which its consequences are felt but are not empirically observable. This practical reality is captured in Mizruchi’s (1983, p. 428) conceptualisations on the definition of control: “it is possible to argue that regardless of how many decisions are made by a particular group of people, that group does not in fact exercise control.” Such is the case for investment fund boards.

The most significant finding of our research in terms of Fama and Jensen’s (1983a) seminal paper is the position of power enjoyed by fund promoter organisations. A discussion of fund promoters’ control and monitoring roles are absent from Fama and Jensen’s (1983a) conceptualisations on the decision control framework of mutual funds. By excluding fund promoters' control and monitoring roles from their theorising on mutual funds, they ignore the practical realities of how funds operate as identified through our research (see Figure 4). Critically, our research has found that many of Fama and Jensen's (1983a) observations and assumptions on decision management vs decision control support fund promoters' control and monitoring roles. We argue that fund promoters should be identified as decision controllers in the context of the separation of decision management and control that characterises the agency problem in investment funds. Capturing this within a theoretical framework is an important step towards developing a more solid investment fund governance framework.

Our findings resonate with Coleman's (2014) observations, following interviews with 34 mutual fund managers, of the lack of applicability of financial decision theory to the real world because of omitted factors, similar to our own conclusions.

6. Discussion

Investment fund boards operate quite differently to corporate boards. It is important to understand these differences so that expectations of others in the complex elements of governance reflect reality in practice, thereby enhancing their effectiveness. Our primary contribution is developing theory that helps us understand the role of boards of investment funds – an important organisational form – that remains under-theorised in the governance literature. There are key differences between corporate boards and investment fund boards that limit the generalisability of prior research on corporate boards to investment funds. Our theory builds on the unique characteristics of investment funds and focuses on the distinctive role of investment fund boards. The framework identifies the factors that influence board empowerment and related effectiveness in executing boards' oversight role. Central to enabling fund boards is the use by fund promoters of their power position. How fund promoters exploit their power position conditions investment fund board effectiveness.

6.1 Contribution to research on boards of directors

Our findings of a more limited role for investment fund boards can be extended to boards of directors of other organisational types or contexts such as subsidiary boards, boards of state-owned entities and organisations with powerful founder shareholder-directors. In such contexts, boards operate under a constraint, often arising from the power dynamics around the board or from shareholder power dynamics (e.g. parent-subsidiary relationships, government-state-owned entity relationships). Similar to investment fund boards, boards with limited power may not be able to exercise control. In relation to subsidiary boards, Huse and Rindova (2001, p. 160-161) observe that "In general, regarding subsidiary boards, central stakeholders are likely to perceive the parent's board as the key control mechanism and emphasize mainly the service role of subsidiary boards". The absence of a control role was eloquently illustrated by Lehman Brothers' daily practice of removing cash from its London subsidiary with dire consequences for the subsidiary.[9] Groot and Merchant (2000) consider the role of boards of directors in control and monitoring international joint ventures. Similarly, boards of directors of state-owned enterprises have limited control arising from being wholly owned by a single shareholder – directors are appointed by government; boards of directors are generally required to implement government policy.

6.2 Interpreting boards' oversight role: An extra layer of oversight

We have identified fund promoters' dominant control role. Critically, there can never be a complete absence of agency problems. For this reason, another layer of oversight is beneficial. The status of investment funds as separate legal entities requires the appointment of boards of directors. Investment fund boards of directors can act as an additional layer of oversight. This involves overseeing the operation of investment funds to ensure they are being managed in the best interests of investors. We find that this layer of oversight is not, and should not be, interpreted as being completely independent of fund promoter organisations. We have established fund promoters' control and monitoring roles. The impact of fund promoters' power, extends beyond the demarcation of control and monitoring vs oversight roles and into fund boardrooms.

6.3 Limitations of the study

As the paper draws to a conclusion, it is appropriate to reflect on the limitations of the research and, where relevant, how these limitations have been addressed. We identify four limitations. First, our research interviewed Irish resident directors. The research might have benefited from discussions with fund directors from other jurisdictions. The primary attraction of sourcing research participants from this pool of directors is the unique position of Ireland as a prominent offshore fund domicile or centre. Second only to Luxembourg, Ireland is a preferred off-shore location for the establishment of funds by global fund promoters. This provides non-executive directors with exposure to a broad spectrum of fund promoter cultures. Many of the research participants sit on boards of USA and European fund promoters thereby providing critical insights into the approaches of fund promoters and fund-promoter executive directors from different countries (and different regulatory regimes) to the governance of investment funds. Second, we did not obtain the perspectives of investment fund investors in considering investment fund boards. Although fund-promoter executive directors provided useful insights into investor effectiveness, it would have been insightful to interpret institutional investors' expectation and experience of investment fund boards. This provides an interesting avenue for future research. Third, a key issue with any qualitative method involving interpretation of interview data is subjectivity. How different would the results be if another researcher replicated the research? This subjectivity may be considered a limitation of the research. Fourth, our definitions in Figure 3 are somewhat categoric. Categories of differentiation are based on the notion of ideal types, which emphasise certain characteristics and understate others. Another drawback is that categories of differentiation are neither exhaustive nor completely mutually exclusive. We thus acknowledge that our three key terms have variation within them and that it is not always possible to precisely delineate each from the other. In practice, the real world can be 'messy' and concepts do not easily slip into neat categories.

6.4 Future Research

The objective of grounded theory is to generate theory. We believe that our theoretical framework in Figure 2 sets a future research agenda. Our research develops Fama and Jensen's (1983a) original theorising on investment fund board roles. The next step is to empirically test our framework. For example, through qualitative modes of enquiry, future research might explore a variety of board structures to identify their fit with the theoretical framework presented in Figure 2. Case study and cross-jurisdictional context-rich analysis could enable researchers to supplement or reduce the emphasis placed on certain contextual and/or behavioural characteristics within the framework. A key element absent from prior research that must be included in future research is the fund promoter, given its dominant control role. Future empirical research based on our theoretical framework is required both to support the ideas in our paper and expand on them as follows:

Fund promoters' use of their power position

The theoretical framework focuses on the attribution of fund promoter power. Fund promoters, rather than fund boards, are the ultimate instrument of power in investment fund settings. We do not present the factors influencing fund promoters' use of their power position in our paper due to space constraints and the risk of obfuscating the research's focus on investment fund board of directors. Further exploration of fund promoters' power position (antecedents and effects) represents an interesting area for both theoretical elaboration and empirical enquiry. Future research might explore these influencing factors and contextualise them within the power theory literature. Data gathered from our research could be supplemented through additional in-depth interviews with senior executives from fund promoter organisations in various jurisdictions.

Investors' perspective of investment fund boards

We did not obtain the views of investment fund investors in considering investment fund board effectiveness. Future research exploring the perspectives of institutional investors on their governance role and their expectations and experiences of investment fund boards will further develop the theoretical framework. In addition, such interpretive research will enhance prior empirical research on investor activity by providing insights into investor behaviour derived from investors themselves.

Execution of investment fund board roles

In any governance context, there will be directors who adopt a ceremonial role rather than their functional role. It is critical that we first understand the role set expected of investment fund directors and then we can evaluate them accordingly in terms of substantive execution. The core objective of our research is to bring clarity to the role of boards in their context thereby improving empirical research in this area and (for regulated entities) regulatory policy. We have shown in our paper that investment fund board roles are constrained and limited to oversight only. Further research is required on directors' role execution – as to whether their limited oversight role is exercised in a substantive or ceremonial manner (Freeman and Peck, 2007; Parker, 2007; Peck 1995; Spira, 1999). This perspective offers another important line of enquiry in researching investment fund boards, particularly in the context of the multiple directorships held by some professional investment fund directors (Nine of the non-executive directors in Table I held more than 20 directorships).

6.5 Conclusion

Our research set out to explore the roles of investment fund boards and the factors that influence the successful execution of these roles. Through an interpretive exploration of directors' lived experiences, we develop theory of the role of investment fund boards. The fund promoter has power – in launching the fund product, preparing the prospectus, appointing board members, investment managers and third party service providers. Figure 1 shows the fund promoter board of directors and the shareholders of the investment fund to have decision control roles. It is not possible or practical for investment fund boards to also have a control role. Rather they have an oversight role. The theoretical framework in Figure 2 captures aspects of fund governance under-explored in prior theorising on investment fund boards. Further, it calls into question the narrow proxies for the conditions and output of board effectiveness used in prior empirical research on investment fund boards (e.g. measures of fund-related outcomes such as fund performance (asset growth, fund inflows/subscriptions, fund expenses/expense ratios, management fees paid to advisors). The theoretical framework presented has explanatory as well as descriptive power across regulatory jurisdictions. Of critical importance is the need for regulatory frameworks of investment fund governance to capture not only fund promoters' control and monitoring roles, but also their ability to influence investment fund board effectiveness.

Notes

[1] Regulated funds are required to have a governance structure that facilitates oversight independent of fund promoter organisations given the inherent conflicts of interest in this particular relationship. Fund promoters (through their investment management division) earn fees based on funds under management and fund performance. In the absence of independent oversight, fund promoters could potentially charge inappropriate fees, grow assets under management until there are diseconomies of scale from an investment perspective or mis-represent fund performance. Investment funds can also be constructed as unit trusts or common contractual funds which are not legal entities and must appoint a management company (with a board of directors) to manage their affairs. All references to investment fund boards apply to management companies in this context.

[2] Typically fund directors are non-executive – i.e. not involved in the day-to-day operation of the fund – however, some work for the fund promoter (which we call "fund promoter executive directors") and others are independent non-executive directors, and do not work for the fund promoter.

[3] Bricker and Chandar (2000) highlight the important influence and control by investment managers of investment funds, which is beyond the scope of our paper.

[4] A detailed description of the methods adopted are available from the authors on request.

[5] While 41 seems like a small number, this is quite a significant group in the context of the funds industry. Ireland is a fund domicile (rather than an asset domicile) and so typically the fund promoter directors are based outside Ireland with non-executive directors typically located inside Ireland (although this is not always the case). Many of these directors hold a portfolio of directorships across a number of fund promoters/funds. At the time of the research, they would have represented at least 75% of the entire investment fund non-executive director population. As such, they would have been representative, although grounded theory does not require that they be so.

[6] Investment fund directors may hold large numbers of directorships for two reasons. First, due to the specialist and technical nature of investment funds, many investment fund directors are full-time, specialist, professional directors, holding no other employments or roles. Second, many professional directors hold multiple directorships in fund families of the fund promoter employing them. The number of directorships held by interviewees is relevant to the research to the extent that: it enabled directors to speak candidly about their role without risk of identifying the relevant fund/fund promoter; it provided access to experiences across a breadth of fund promoters and their products and as such provided jurisdictional variance. The role of oversight, while important and functional, is much narrower than the role of control. Thus, professional, investment-fund non-executive directors can take on a wider portfolio than non-executive directors on traditional company boards. In addition, there are synergies enabling oversight for investment fund non-executive directors who have a number of funds within one fund-promoter family. As a fund is a product, strategy is set at the outset and is maintained for significant periods of time, unlike a traditional company. The execution of (investment) strategy of the product is outsourced to specialists. In overseeing the critical issue of fund performance, non-executive directors should explore the macroeconomic

conditions prevailing, market sentiment, bond yields, etc. Much of this technical analysis is common across portfolios. Fund boards meet on average once per quarter, which is considerably less frequent than listed companies or financial institutions.

[7] We do not discuss theoretical categories IV and V further as the findings reflect what is already known in the prior literature about the behaviour of non-executive directors' concerning their ability and effort levels in exercising their roles.

[8] This phrase comes from the following quote: "I want you wearing your director's hat. Each director is equally responsible with me for directing the company. You are not there to represent your function, your divisional company. Nor are you there to defend your executive performance or bid for resources for your executive activities. You are there to help me govern the company overall." (Lord Caldecote's Advice to Executive Directors, Tricker 2015, p. 92).

[9] "Lehman Brothers filed for Chapter 11 bankruptcy protection on 15 September 2008. At Lehman, it was procedure that all spare cash held by the London subsidiary – a corporate entity subject to British bankruptcy legislation – was sent to the New York parent at the close of each business day. When the directors of this subsidiary realised on Sunday 14 September 2008 that their US parent was going to file for bankruptcy protection the next day, they realised they no longer had the cash to fund their operations. Under British law this meant that the company had to be put into administration and, as a consequence, its access to exchanges and clearing systems was frozen with a large number of trades left open." (European Union, 2012, p. 4).

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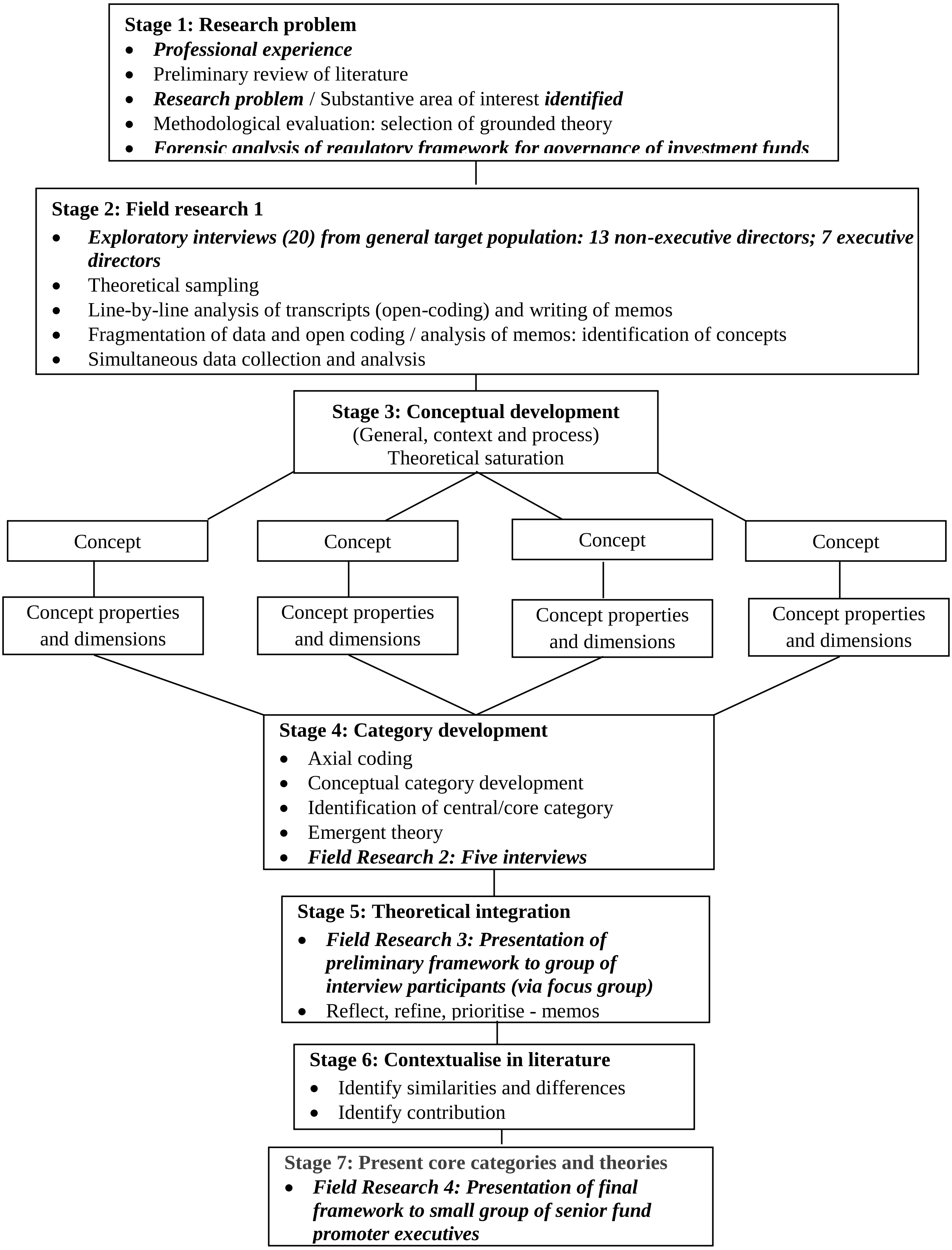
Figure A1
Theory Building using Grounded Theory: Approach Adopted in this Research



Source: Adapted from Goulding (2002: 115)
Note: Bold italic text highlights the methodology specific to this research