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Committed to Strong Fund Governance

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April 20, 2020

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles; File No. S7-24-15

Dear Ms. Countryman:

The Independent Directors Council[1] appreciates the opportunity to comment on the Commission's re-proposed derivatives rule.[2] The re-proposal addresses many of the concerns raised by IDC and other commenters to the 2015 Proposal,[3] and we commend the Commission for being responsive to those comments. For example, the proposed limits on fund leverage risk represent a much more workable approach than the portfolio limits contained in the 2015 Proposal. Moreover, the proposed board responsibilities in the re-proposal reflect a better governance approach to derivatives oversight than those in the 2015 Proposal. For this reason, IDC strongly supports the re-proposal.

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[1] The Independent Directors Council ("IDC") serves the US-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute ("ICI") member funds. ICI is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI's members manage total assets of US$24.1 trillion in the United States, serving more than 100 million US shareholders, and US$7.7 trillion in assets in other jurisdictions. There are approximately 1,600 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] *See Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles*, 34-87607; IA-5413; IC-33704; File No. S7-24-15 (Nov. 25, 2019) ("Release"), available at https://www.sec.gov/rules/proposed/2019/34-87607.pdf.

[3] *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Release No. IC-31933, (Dec. 11, 2015), available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf ("2015 Proposal").

Board oversight of a fund's use of derivatives has been and remains critically important. At the same time, it is also essential to recognize the oversight role of fund boards relative to the portfolio management activities for which the investment adviser is contracted to provide. Consequently, while we are very appreciative of the changes to board responsibilities contained in the re-proposal, we continue to have reservations about the proposed reporting relationship of the derivatives risk manager ("DRM") to the board, including the requirement that a board approve the designation of the DRM, taking into account the DRM's relevant experience. Fundamentally, a board's oversight of a fund's use of derivatives is a component of its oversight of portfolio management. While investment in derivatives, like other asset classes, presents unique elements, it is part of the core investment management responsibilities of the adviser.

Accordingly, we believe that the following modifications to the re-proposal would better reflect an appropriate oversight role for fund boards:

- The adviser should be permitted to administer the derivatives risk management program subject to board oversight, and boards should not be subject to prescriptive regulatory requirements that, in our view, would effectively require review of the adviser's personnel.
- The rule should permit greater flexibility regarding the level of detail in board reports and allow them to be tailored to the circumstances of the fund, including its use of derivatives.
- Because of the broad oversight role that fund boards are required to exercise, any adopting release should refrain from dictating particular protocols that a board must follow in its oversight of the use of derivatives.

Before discussing these recommended modifications, we provide background on a fund board's oversight role and an overview of the re-proposal.

I. Background on Board Oversight Role

As we have noted previously, fund directors already provide robust oversight of funds' use of derivatives as part of their general oversight of portfolio management and investment risk.[4] They have been performing this role for more than 30 years, since funds started using derivatives to implement their investment strategies. Boards recognize that the features, benefits, risks, and resource requirements of derivatives use may, in some situations, merit greater board attention, and boards exercise heightened review as circumstances call for it.

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[4] *See* Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, Secretary, SEC regarding Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15) (Mar. 28, 2016), available at https://www.sec.gov/comments/s7-24-15/s72415-123.pdf ("IDC 2016 Comment Letter").

Federal and state law recognize that the role of fund directors is to represent the interests of fund shareholders through independent oversight and not through management of the fund. This governance structure is key to the effectiveness of board oversight, as directors are most effective in representing shareholders' interests when they can provide an independent perspective, removed from the day-to-day activities of fund management. Fund directors' ability to view a matter as independent overseers allows them to see the forest through the trees and to focus on what is important to fund shareholders. Requiring boards to engage in a management function could impair that independent perspective and the governance structure that works effectively for shareholders.

We recognize and appreciate that the re-proposal would not require boards to make the kinds of determinations that were included in the 2015 Proposal. We are mindful, however, that even incremental requirements can lead to a shift in perception as to where to draw the oversight-versus-management line for board responsibilities in the future. Importantly, our view is not that directors' responsibilities should be reduced, but rather, that they should be designed to enable directors to provide effective, independent oversight on behalf of shareholders.

II. Overview of Re-Proposal

The proposed derivatives rule[5] would permit funds to enter into derivatives transactions, notwithstanding the restrictions under Section 18 of the Investment Company Act of 1940 ("1940 Act"), provided that they comply with the conditions of the proposed rule.[6] Under the proposed rule, a fund would have to comply with a limit on fund leverage risk based on the fund's value at risk ("VaR") and adopt and implement a derivatives risk management program with the following elements: risk identification and assessment; risk guidelines; stress testing; backtesting; internal reporting and escalation; and periodic review of the program.

Under the proposed rule, the derivatives risk management program would have to be administered by a DRM. The DRM would have to be an officer or officer(s) of the fund's adviser and may not be a portfolio manager of the fund (or, if multiple officers serve as the DRM, may not have a majority composed of portfolio managers of the fund). The DRM also would have to "have relevant experience regarding the management of derivatives risk." The board would have to approve the designation of the DRM, taking into account the DRM's "relevant experience regarding the management of derivatives risk." Unlike the 2015 Proposal, the re-proposal would not require the board to approve the derivatives risk management program.

The DRM would be required to provide the following types of reports to the board:

- *Program implementation and effectiveness*. The DRM would have to provide the board on or before implementation and, at least annually thereafter, a written report

[5] Proposed Rule 18f-4 under the Investment Company Act of 1940.

[6] Under Proposed Rule 18f-4, a fund would not be required to adopt a derivatives risk management program or comply with the limit on fund leverage risk, if the fund either limits its derivatives exposure to 10 percent of its net assets or uses derivatives transactions solely to hedge certain currency risks.

providing a representation that the program is reasonably designed to manage the fund's derivatives risks and to incorporate the required elements of the program. The report also would have to include "the basis for the representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program." The report must include the DRM's basis for the selection of the designated reference index or, if applicable, an explanation of why the DRM was unable to identify a designated reference index appropriate for the fund.

- *Regular board report*. The DRM would have to provide, at a frequency determined by the board, a written report regarding the DRM's analysis of any risk guideline exceedances and the results of stress testing and backtesting. Each report would have to include such information as may be reasonably necessary for the board to evaluate the fund's response to any exceedances and the results of the fund's stress testing.

In addition, the DRM would have to directly inform the fund's board, as appropriate, of material risks arising from the fund's derivatives transactions, including risks identified by the fund's exceedance of a criterion, metric, or threshold under the fund's risk guidelines.

III. Comments on the Re-Proposal

A. IDC Agrees that Board Approval of the Derivatives Risk Management Program Should Not Be Mandated

The re-proposal would not require the board to approve the derivatives risk management program, and we agree with this approach. As stated in our comment letter on the 2015 Proposal, we support requiring funds that make more than limited use of derivatives in their investment strategies to adopt a derivatives risk management program, with the board's role in connection with the program being consistent with its oversight function.[7]

The Commission asks whether it should "require a fund's board, or a committee thereof, to approve the derivatives risk management program or any material changes to the program" and whether such an approval requirement would "promote greater board engagement and oversight."[8] As noted above, fund boards already provide robust oversight of funds' use of derivatives, and a new regulatory requirement that they approve a derivatives risk management program is not necessary for them to provide effective oversight.

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[7] *See* IDC 2016 Comment Letter, *supra* n. 4.

[8] *See* Release, *supra* n. 2, at 84 (Question 64). Commissioners Jackson and Lee raised a similar question in a separate statement. *See* Statement of Commissioners Robert J. Jackson Jr. and Allison Herron Lee on Proposed Rules on Funds' Use of Derivatives (Nov. 26, 2019), available at https://www.sec.gov/news/public-statement/jackson-lee-statement-proposed-rules-funds-derivatives.

A board's oversight of a fund's use of derivatives is part of its general oversight of portfolio management.[9] A fund's board oversees the adviser's management of the fund's portfolio pursuant to the directors' fiduciary duties to the fund under state law and their statutory responsibilities to annually review and approve continuation of the adviser's contract with the fund under Section 15(c) of the 1940 Act.

Just as board oversight of portfolio management generally does not require directors to be technical experts regarding asset allocation, securities selection, or attribution analysis, board oversight of a fund's use of derivatives does not require directors to be derivatives experts. A fund's board can tailor its oversight function appropriately based on the circumstances of the fund, such as the level and complexity of the fund's use of derivatives.

B. The Investment Adviser Should Be Permitted to Administer the Derivatives Risk Management Program

We recommend that the investment adviser administer the derivatives risk management program. If the Commission determines that the program should be administered by a DRM, then the rule should permit the investment adviser to serve in this role, just as an adviser can serve as the administrator of a liquidity risk management program.[10]

Under the re-proposal, the DRM would have to be an officer or officer(s) of the fund's adviser, and the board would have to approve the DRM's designation, "taking into account the [DRM's] relevant experience regarding the management of derivatives risk." While the 2015 Proposal would have required the DRM to be a single individual, the re-proposal would permit a group of individuals to serve in this role. This change is an improvement, but IDC continues to believe that it is unnecessary to mandate board approval of specific individuals as the DRM.

A fund's use of derivatives does not present a potential conflict of interest between the adviser and the fund that would warrant this level of involvement by the board. Moreover, requiring the board to approve the designation of specific personnel—and to evaluate the relevant experience of a candidate—draws them too far into the management function. It also clouds the reporting lines for those personnel[11] and, importantly, creates yet another reporting relationship of this type with the board with siloed reporting protocols. The resulting potential for inefficient workstreams can be counter effective in the oversight of a fund's investment risks, including

[9] *See* IDC Task Force Report, *Board Oversight of Derivatives* (July 2008) at 2, available at http://www.idc.org/pdf/ppr_08_derivatives.pdf; *see also*, IDC, *Investment Performance Oversight by Fund Boards* (October 2013), available at https://www.idc.org/pdf/pub_13_performance_oversight.pdf.

[10] *See* Rule 22e-4(a)(13) under the 1940 Act.

[11] Although a fund board does approve the designation of the chief compliance officer ("CCO") (and the CCO's compensation), the CCO role is significantly different than that of a DRM. The CCO administers the fund's compliance program—an area in which there are potential conflicts of interest between the adviser and the fund—and it is appropriate that the board approve the designation of the person serving in this role. In contrast, a fund's use of derivatives does not present conflicts of interest that would warrant establishing a similar reporting relationship with the board.

derivatives risks. Along with the cost burdens associated with the proposed approach—particularly for smaller funds—we believe that the separate required designation of a DRM and the associated board reporting structure are unnecessary to meet the legislative intent of the 1940 Act and the Commission's regulatory goals.[12]

Thus, we recommend that the adviser be able to administer the derivatives risk management program. The adviser should have the requisite expertise and knowledge concerning the fund's investment strategies and risks, including its derivatives risks, and would have the responsibility under the advisory contract to provide investment management services.

We also question the regulatory requirement that the board's approval take into account the DRM's relevant experience regarding the management of derivatives risk. This standard creates the possibility for subsequent second-guessing of board decisions.[13] It is not clear what scope of experience would suffice or whether experience in related fields (e.g., accounting, compliance, trading) could satisfy the proposed rule. In addition, neither the liquidity risk management rule nor the compliance program rule imposes such a regulatory standard with respect to the board's approval of the designation of the liquidity risk management program administrator or CCO, respectively. The Release does not explain the basis for singling out—through a regulatory mandate—an affirmative obligation with regard to a particular class of investments—in this case, derivatives.

We believe that determining the qualifications of key personnel, such as portfolio or risk managers, is a management function that boards are best positioned to oversee, but not to perform themselves. We therefore believe the Commission should allow a fund's board to provide its approval based on its own reasonable business judgment, considering the factors it deems appropriate based on the facts and circumstances of the fund.

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[12] We note that, when it adopted Rule 38a-1, the Commission stated that having a single CCO was designed to combat then current practices of "balkan[izing]" responsibility for compliance, which impeded boards' abilities to exercise their oversight responsibilities effectively. *See Compliance Programs of Investment Companies and Investment Advisers*, Release Nos. IA-2204 and IC-26299 (Dec. 17, 2003), available at https://www.sec.gov/rules/final/ia-2204.htm.

[13] We note that the Release states that requiring the DRM to be approved by the board and with "relevant experience as determined by the fund's board" is "consistent with the way we believe many funds currently manage derivatives risks." *See* Release, *supra* n. 2, at 80. The Release then cites to IDC's June 2016 supplemental letter on the liquidity risk management and derivatives rule proposals. *See* Letter from Paul K. Freeman, Chair, IDC Governing Council, to Brent J. Fields, Secretary, SEC, regarding Supplemental Comments on Liquidity Risk Management and Funds' Use of Derivatives Proposals (Jun. 22, 2016), available at https://www.sec.gov/comments/s7-16-15/s71615-154.pdf. IDC's 2016 supplemental letter, however, describes an oversight process in which boards ask "whether management has sufficient resources, including experienced and qualified people, dedicated to the fund." The letter does not suggest—and we do not support—placing the burden on the board to make determinations about the qualifications of specific personnel. The board relies on the adviser, which is contractually responsible for delivering investment management services, to determine the organizational structure and staffing that is appropriate to provide those services to the fund.

C. The Rule Should Permit Greater Flexibility Regarding the Content of Board Reports

We recommend that the rule permit greater flexibility regarding the level of detail required to be included in board reports. The proposed rule would require the DRM's regular report to provide the DRM's analysis of any risk guideline exceedances and the results of stress testing and backtesting. In addition, the DRM's reports would have to include "information as may be reasonably necessary to evaluate" the DRM's assertions in the reports. For example, under the proposed rule, the DRM would have to provide a representation that the program is reasonably designed to manage the fund's derivatives risks and include "the basis for the representation along with such information as may be reasonably necessary to evaluate the adequacy of the fund's program." The report also must include the DRM's basis for the selection of the designated reference index or, if applicable, an explanation of why the DRM was unable to identify one.

We recommend that the rule simply require annual and periodic reports (whose frequency is determined by the board) and allow the board and the DRM to determine the appropriate format and content. For instance, a board should be able to receive executive summaries, rather than the more detailed reports suggested by the re-proposal, if the board deems that format to be appropriate and useful to facilitate its oversight responsibilities. Boards may not need to review every exceedance to provide effective oversight of the adviser's risk management function, as would seem to be required by the re-proposal. They can receive summary reports that help them evaluate how well the adviser is managing the fund within the risk guidelines and can follow up if they determine that additional detail or information would be useful. Or, in some cases, a board might seek more detailed reports for a period of time, such as when a program or process is new, and then shift to summary-level reports. Whichever the case, boards should be able to tailor their oversight to the particular circumstances of the fund, including with respect to the format and level of detail in board reports.

Similarly, the proposed requirement that the DRM provide information to help the board evaluate the DRM's assertions seems to suggest that the board should routinely second-guess or challenge the DRM's determinations on technical matters. Given that the DRM is intended to be the subject-matter expert, the board should be able to generally rely on the DRM's determinations. The board, in the exercise of its business judgment, may have additional questions and seek additional detail, as they currently do. But the level of information specificity and the extent of the board's inquiry should be determined by the board, based on the facts and circumstances of the fund it oversees, and should not be imposed through a regulatory requirement. Given the experience of boards in overseeing funds' use of derivatives, we do not believe that a prescriptive reporting mandate is warranted.

D. The Adopting Release Should Refrain from Mandating Particular Protocols for the Board's Oversight of Derivatives

Our concern that the Commission is expecting the board to play a role that extends beyond its oversight role is also based on the Release's description of a board's responsibilities.[14] The Release describes an "iterative process" that it expects boards to undertake in overseeing funds' use of derivatives. The Release states that the board should inquire about material risks and "follow up regarding the steps the fund has taken to address such risks." Whether it is necessary for a board to carry out such an "iterative process" should depend on the facts and circumstances of a particular fund.

We believe that fund boards can determine when and to what extent follow-up is needed after receiving a report. Depending on the circumstances, regular follow-up may or may not be necessary, as the reports provided to the board may already contain sufficient information, or the matter may have been resolved. The Release's language seems to suggest that boards are regularly expected to engage in a back-and-forth process that could drive the reporting and discussions to a more granular level than is necessary or efficient for the board's oversight role. Thus, we recommend that the adopting release not include this language.

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[14] Release, *supra* n. 2, at 80-81.

IDC strongly supports the re-proposal, which addresses many of the concerns that we and other commenters expressed with respect to the 2015 Proposal. Fund boards stand ready to continue to provide strong oversight of derivatives investments as part of the adviser's portfolio management activities. The recommendations above, in our view, would enhance the oversight function in a way that strengthens effective fund governance. If you have any questions about our comments, please contact Annette Capretta, Deputy Managing Director, at (202) 371-5436 or me at (202) 326-5463.

Sincerely,

Thomas T. Kim
Managing Director
Independent Directors Council

cc: The Honorable Jay Clayton
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman
The Honorable Allison Herren Lee

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