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March 28, 2016

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)

Dear Mr. Fields:

The Independent Directors Council[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposal concerning funds' use of derivatives.[2] The Commission proposes to replace the current patchwork of Commission and staff guidance regarding derivatives investments with a new rule. Proposed rule 18f-4 under the Investment Company Act of 1940 ("1940 Act") would impose new constraints on funds' use of derivatives and new responsibilities on fund boards.[3] Our letter focuses on the implications of the proposal on the role and responsibilities of fund boards.

The proposed new fund board responsibilities under this proposal follow on the heels of the liquidity risk management program proposal and money market fund reforms, both of which look to

[1] IDC serves the U.S.-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 member funds. ICI is a leading, global association of regulated funds, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the U.S., and similar funds offered to investors in jurisdictions worldwide. ICI's U.S. fund members manage total assets of $16.9 trillion and serve more than 90 million U.S. shareholders, and there are approximately 1,900 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, SEC Release No. IC-31933, (Dec. 11, 2015), available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf ("Release").

[3] The Release states that the "proposed rule's conditions are designed both to impose a limit on the leverage a fund may obtain through the use of derivatives and financial commitment transactions and other senior securities transactions, and to require the fund to have assets available to meet its obligations arising from those transactions." Release, *supra* n. 2, at 9.

impose new and significant responsibilities on fund boards.[4] Although we agree that it is generally appropriate for fund boards to oversee these important areas, we also caution the Commission to be mindful about the effect each new initiative has on the totality of fund board responsibilities. Therefore, in addition to considering the comments we discuss below with respect to this proposal, we urge the Commission to consider taking a step back to evaluate all of a fund board's responsibilities and whether they all continue to be appropriate, particularly now that funds are required to have compliance programs administered by chief compliance officers ("CCOs").[5] We believe that the effectiveness of fund boards in focusing on the matters of greatest interest to fund shareholders and where directors add the greatest value could be enhanced with some modifications to existing rules.[6]

Proposed rule 18f-4 would impose on fund boards three primary new responsibilities with respect to derivatives transactions:

- approve one of two alternative portfolio limitations;
- approve asset segregation policies and procedures, including for determining the risk-based coverage amounts; and
- for certain funds, approve a derivatives risk management program and any material changes to the program, approve the designation of a derivatives risk manager, and review quarterly reports regarding the program.[7]

As discussed more fully below, we believe that the proposal should be revised in a manner that appropriately acknowledges and reflects the board's oversight role. We believe that the requirement that boards approve the particular portfolio limitation draws fund boards too closely into a management function and is not necessary to support the Commission's policy goals. We also are

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[4] *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, SEC Release No. IC-31835 (September 22, 2015) ("Liquidity Risk Management Proposal"), available at https://www.sec.gov/rules/proposed/2015/33-9922.pdf and rule 2a-7 under the 1940 Act.

[5] *See* rule 38a-1 under the 1940 Act.

[6] We urge the Commission to resurrect the Director Outreach Initiative, whose goal was to determine: "What can or should the Commission do in order to aid fund directors in the performance of their duties?", *see* Keynote Address of Andrew J. Donohue, Director, Division of Investment Management, SEC (November 28, 2007), available at https://www.sec.gov/news/speech/2007/spch112807ajd.htm. At the time of that initiative, we offered preliminary recommendations for enhancing fund board effectiveness (*see* Letter from Robert W. Uek, Chair, IDC Governing Council, to Andrew J. Donohue, Director, Division of Investment Management, SEC (February 26, 2008)), and could provide an updated set of recommendations to assist the Commission on such a project. *See also* Matthew P. Fink and Jacqueline Edwards, "The Changing Role of Independent Directors of Mutual Funds," The Investment Lawyer, Vol. 23, No. 4 (April 2016).

[7] With respect to financial commitment transactions, the board would be required to approve policies and procedures reasonably designed to provide for the fund's maintenance of qualifying coverage assets. *See* proposed rule 18f-4(b)(2).

concerned that the requirement that the risk-based coverage amounts for asset segregation be determined by board-approved policies and procedures invariably would require that boards engage too deeply into an analysis concerning the appropriate "cushion" to include for each type of derivative instrument. In both cases, the proposal would impose on fund boards a responsibility for management functions that are inconsistent with their oversight role. We, therefore, suggest that the Commission eliminate the requirement that boards approve the particular portfolio limitation and make clear that a fund's board-approved asset segregation policies and procedures can assign to the adviser the responsibility for determining the methodologies for calculating risk-based coverage amounts. In both cases, we would expect that a fund would still be subject to an overlay of compliance-related policies and procedures—governed by the well-understood framework of rule 38a-1 under the 1940 Act and subject to board oversight.

Regarding the proposed derivatives risk management program, we support requiring funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions to adopt a program, with oversight by the fund board. We recommend some clarifications and modifications to this requirement, however, which we discuss below.

Finally, we are aware that members of the Commission staff have stated that the proposal is not intended to impose management functions on fund boards.[8] While we do not question their sincerity, we note that many in the director community and others in the industry view the proposal quite differently. Rather than emphasize the board's role in overseeing the portfolio management function, the proposal seems to push boards into the realm of the decision-making that is part of the portfolio management function and more appropriately within the adviser's purview. We view the portfolio management function as the core service that the adviser is contracted to provide the fund, and board oversight involves an ongoing dialogue with the adviser about the risks and benefits of many of the complex portfolio management activities, such as derivatives use, securities lending, and portfolio trading. Fund directors are not engaged on a day-to-day basis in fund management and operations and do not have, nor should they be expected to have, the technical, on-the-ground expertise of the adviser and other service providers.[9] To reconcile these differing views, we urge the Commission to modify the proposal as we suggest below and to characterize directors' responsibilities consistent with its statements that it is not intending to impose management functions on fund boards.

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[8] *See e.g.*, Remarks by David Grim, Director, Division of Investment Management, SEC (March 3, 2016), available at https://www.sec.gov/news/speech/remarks-to-pli-investment-management-institute-2016.html.

[9] Comments suggesting that boards play the role of "gatekeepers" seem to suggest a role for boards that is different from one of oversight. *See e.g.*, Remarks by SEC Chair, Mary Jo White, "A Few Things Directors Should Know about the SEC" (June 23, 2014), available at https://www.sec.gov/News/Speech/Detail/Speech/1370542148863 and Remarks by SEC Chair, Mary Jo White, at the Securities Enforcement Forum (October 9, 2013, available at https://www.sec.gov/News/Speech/Detail/Speech/1370539872100.

1. Fund Boards Already Provide Robust Oversight of Funds' Use of Derivatives

The Commission states that it is proposing to impose on boards certain new responsibilities to "appropriately focus the board's attention,"[10] but as we discuss below, fund boards already are well-focused on overseeing the use of derivatives as part of their general oversight responsibilities on behalf of fund shareholders.

a. The Appropriate Role of Fund Boards is Oversight, Not Management

Oversight of a fund's use of derivatives is part of the board's general oversight of portfolio management.[11] As such, board oversight of derivatives is generally the same as it is with respect to other portfolio investments, although the particular features, benefits, risks, and resource requirements of derivatives use may, in some circumstances, merit greater board attention.[12] A fund's board oversees the adviser's management of the 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. The adviser manages the fund's portfolio investments as part of its responsibilities under the advisory contract with the fund and its own fiduciary duties to the fund. In addition to overseeing the adviser's management of the fund consistent with the fund's prospectus and other disclosures (including the adviser's use of derivatives of various types), the board oversees how well the adviser is investing and managing the portfolio for the fund's shareholders.

Moreover, the fund board approves all compliance-related policies and procedures under rule 38a-1 under the 1940 Act. Indeed, we question why the Commission is proposing that a board be required to approve specific policies and procedures or determinations relating to the portfolio management and investment risk management functions, when the rule 38a-1 governance framework calls on boards to provide robust oversight. Under rule 38a-1, a fund relying on the conditions of proposed rule 18f-4 would need to adopt policies and procedures reasonably designed to prevent violations of that rule and the board would be required to approve those policies and procedures and oversee compliance with them. Thus, if a fund were required to comply with a portfolio limitation or maintain qualifying coverage assets that include mark-to-market and risk-based coverage amounts, then the fund would have to adopt policies and procedures designed to comply with those requirements. We

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[10] *See* Release, *supra* n. 2, at 149 and 156.

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

[12] *See* IDC Derivatives Report, *supra* n. 11, at 1; *see also generally* Letter from Dorothy A. Berry, Chair, IDC Governing Council, to Elizabeth M. Murphy, Secretary, SEC, regarding Use of Derivatives by Investment Companies under the Investment Company Act of 1940; File No. S7-33-11 (November 7, 2011) ("IDC Concept Release Letter").

believe that this well-established framework provides ample protection of investors' interests while utilizing the fund board in its most appropriate and valuable capacity: as the independent overseer.

The Release does not assert that a fund's use of derivatives, instead of cash securities, to implement an investment strategy introduces or increases any potential conflict of interest between the adviser and the fund.[13] Indeed, we believe the interests of advisers and funds (and fund boards) generally are aligned when it comes to derivatives transactions, because advisers do not want to manage derivatives in a way that could cause significant, unexpected losses. Any such losses—especially if they are severe—could adversely affect the adviser's reputation.

We also do not believe that the use of derivatives presents a conflict that is any different than that presented by the use of cash securities. Derivatives transactions represent a tool or method for portfolio management to implement (or protect) an investment strategy. If a portfolio manager had an incentive to boost performance with investments that are inconsistent with the fund's risk profile, that potential conflict would be no different whether the manager used derivatives or cash securities to make those investments. Of course, such a potential conflict of interest would already be addressed through the fund's controls, its compliance program, and the board's oversight. Therefore, we do not believe that a fund's use of derivatives would warrant requiring fund boards to make specific determinations, as may be the case with situations that present intrinsic conflicts, such as affiliated transactions.

A fund's use of derivatives also should not require that a board include directors who are derivatives experts, though some boards may choose to do so. Board oversight of portfolio management does not require directors to be technical experts regarding asset allocation, securities selection, or attribution analysis, and the same should be true of funds' use of derivatives. Board oversight requires gaining a general understanding of how and why a fund uses derivatives and whether the adviser has the expertise, experience, and resources to deliver the advisory services it has contracted to perform for the fund and its shareholders (practices we describe in the next section). Oversight does *not* mean that directors second-guess or micro-manage the portfolio management decisions of the adviser. For example, risks (and benefits) associated with derivatives transactions, including liquidity risk, are highly technical and market-driven, and the adviser is in the best position to identify and manage those risks (and benefits). Boards clearly can and should oversee the adviser's activities in this area, but they are hardly in a position to perform these functions themselves.

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[13] The Release does not identify a potential conflict of interest that would warrant the board's heightened involvement in connection with the proposed portfolio limitation or asset segregation policies and procedures. The Release states that the Commission proposes to require the board to have certain responsibilities in connection with the derivatives risk management program, because use of derivatives is an area where there may potentially be conflicts of interest, but it does not explain the nature of these conflicts or how they would be any different from potential conflicts that already exist in the portfolio management function. *See* Release, *supra* n. 2, at 226.

As the American Bar Association explained in its task force report on funds' use of derivatives, the fund board's role is one "of oversight" and "directors should not be required to cross the line to micro-manage a fund's use of derivatives."[14] The ABA Report also stated that board oversight of derivatives is "analogous to its oversight of a fund's investments and/or compliance program" and oversight of derivatives "should not create any new or different responsibilities for a board."[15] We agree.

b. Board Oversight Practices are Robust

Fund boards recognize that derivatives can be an effective tool in portfolio management and, thus, support funds' use of them. Board oversight practices vary and depend upon, among other things, the extent to which derivatives are used to implement a fund's investment strategies. For example, the board of an index fund that uses futures solely to efficiently invest (equitize) cash may not find it necessary to devote as much time and attention to the fund's derivatives investments as might the board of an actively-managed fund with complex derivatives holdings and strategies. In some cases, a board may approve fund policies that establish parameters for the adviser to follow, such as categories of derivatives in which the fund may invest or the use of derivatives (*e.g.*, hedging only); some boards may review new categories of derivatives before the fund invests in them.

Fund directors seek a general understanding from the adviser of the nature, benefits and risks of the types of derivatives the adviser may use, as well as of the purposes for which they are used in a fund's portfolio. In order to achieve this general understanding, boards may discuss with the adviser, among other things, the:

- types of derivatives in which the fund may invest, the investment rationale for using these instruments (*e.g.*, to gain or reduce exposure), and the potential benefits and risks associated with their use;
- expertise and experience of the adviser and relevant service providers with respect to derivatives as well as their operational resources, internal controls, and organizational structures; and
- policies and procedures designed to identify and control risks associated with derivatives, including protocols for routine and event-related reporting to the board.

[14] *See* Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("ABA Report") at 46.

[15] *Id*. at n. 30.

The board also may discuss with the adviser its processes for ongoing measurement and analyses of portfolio risks, including leverage, counterparty and credit exposure, illiquidity, and the potential impact of worst-case scenarios.

In some cases, a fund board may rely on assistance from others, such as a consultant, fund or board counsel, or the fund auditor to help it understand and evaluate a fund's use of derivatives and related matters. In addition, the board may rely on the fund's CCO with respect to compliance matters, including compliance with fund disclosures and policies and procedures.

2. Approval of the Particular Portfolio Limitation is Not an Appropriate Board Role

The Commission proposes to require funds to comply with one of two alternative portfolio limitations and for the fund board, including a majority of the independent directors, to approve the particular portfolio limitation under which the fund will operate.[16] The Commission asserts that requiring the board to approve the particular portfolio limitation would "appropriately focus the board's attention on the nature and extent of a fund's use of derivatives and other senior securities transactions as part of its investment strategy."[17] The Commission does not suggest that the selection of the particular portfolio limitation presents a conflict of interest.[18]

We suggest that the Commission modify the requirement to permit a fund to comply with either limitation, without obtaining prior board approval.[19] First, the proposed board-approval requirement draws fund boards too far into a management role. It effectively (or potentially) puts the board in the position of choosing the preferred alternative through the approval process. The adviser, which has the requisite expertise, can best determine which method would be the most efficient portfolio limitation for the fund to follow. Boards do not have, nor should they be expected to have, the expertise to analyze which portfolio limitation is preferable. As overseers, fund boards can ask questions about and otherwise probe the adviser's decision-making process. This is how they add value to the process for the benefit of shareholders, not by engaging themselves in management-type activities.

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[16] Proposed rule 18f-4(a)(1) and (a)(5)(i).

[17] Release, *supra* n. 2, at 149-50.

[18] We note that the proposed board approval must include approval by a majority of the independent directors. A specific approval by the independent directors generally should be required only to address a significant potential conflict of interest concern.

[19] Other commenters may recommend additional changes to the proposed portfolio limitations, such as eliminating the requirement or consolidating the two portfolio limitations. Such changes would effectively eliminate the board-approval requirement as well. *See e.g.,* Letter from David W. Blass, General Counsel, ICI to Brent J. Fields, Secretary, SEC, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies; File No. S7-24-15 (March 28, 2016).

Second, the determination of which portfolio limitation to follow does not present a conflict of interest that would warrant specific approval by the board. By allowing funds to comply with either limit, the Commission itself acknowledges that either would be acceptable for the protection of funds and their shareholders. Third, fund boards are already appropriately focused on funds' use of derivatives and do not need to be subject to the proposed specific approval requirement to "appropriately focus" their attention.

Finally, requiring a fund board's approval could unnecessarily impede the efficient management of the fund if, for instance, the fund wants to quickly shift from using one of the methods to the other. That might be the case, for example, if a fund determined that entering into additional risk-limiting derivatives transactions would be beneficial to the fund. If those transactions were to cause the fund to exceed the exposure-based limit but still satisfy the risk-based limit, the fund should be permitted to change limitations without having to first obtain board approval, for the benefit of the fund's shareholders.[20]

We note that the requirement that a fund comply with one of two portfolio limitations would already be subject to the rule 38a-1 compliance framework, which benefits from both administration by the fund's CCO and oversight by the fund board. We believe that our suggested approach satisfies the policy goals of the Commission without unnecessarily drawing fund boards into decision-making that is outside their oversight role.

3. Boards Should Not be Tasked With Approving Specific Methodologies in Asset Segregation Policies and Procedures

Under proposed rule 18f-4, a fund would be required to manage risks associated with its derivatives transactions by maintaining qualified coverage assets with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts. The fund board (including a majority of the independent directors) would be required to approve policies and procedures reasonably designed to provide for the maintenance of qualifying coverage assets. The policies and procedures would be required to provide for the determination of the risk-based coverage amount and take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset. The Release notes that the policies and procedures "could use one or more financial models to determine the risk-based coverage amount" or stress testing.[21]

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[20] If the Commission nevertheless determines that the board should approve the particular portfolio limitation, we urge the Commission to make clear that a board could: (1) establish conditions in advance under which the adviser would be permitted to switch from one portfolio limitation requirement to the other without further board action; or (2) delegate to one director the authority to approve switching from one portfolio limitation to the other, subject to ratification by the board at its next meeting.

[21] Release, *supra* n. 2, at 169-70.

Similar to its statements in connection with the portfolio limitations requirement, the Commission asserts that the reason to place this responsibility on fund boards is that it "appropriately would focus the board's attention on the fund's management of its obligations under derivatives transactions and the fund's use of the exemption provided by the proposed rule."[22] Noting that proposed rule 18f-4 would be an exemptive rule, the Commission also states that it believes that "requiring the fund's board to approve these policies and procedures, in conjunction with the board's oversight of the fund's investment adviser more generally," is appropriate.[23] Again, the Commission does not suggest that the asset segregation requirement raises a conflict of interest that would warrant requiring the board to make specific determinations.

The proposed requirement that the policies and procedures take into account certain factors relating to the derivatives transactions, and the suggestion in the Release that they may include financial models, raise a question concerning the level of technical detail that would be expected to be included in the policies and procedures and whether boards would be called upon to approve specific methodologies for calculating the risk-based coverage amounts. For such a policy to be approved by the board, it would seem that the directors would need to dive into a deeper level of detail regarding each type of derivative's characteristics, the investment strategies it facilitates, and the effect stressed conditions could have on it than would be consistent with an oversight role.

We recognize that when the Commission considers a principles-based approach that gives funds some measure of flexibility, as it proposes for asset segregation, it does so with the view that there should be some sort of independent check on that discretion. Although we appreciate that view, we caution against the tendency to look to fund boards to provide that independent check by assigning to them management-type responsibilities, particularly when there is not an identified conflict of interest.

To avoid this result, we suggest that the Commission make clear—in the text of any final rule—that the board-approved asset segregation policies and procedures do not need to set forth specific methodologies for calculating risk-based coverage amounts. Rather, the policies and procedures can set forth general factors or considerations and assign to the adviser the responsibility of developing methodologies for determining risk-based coverage amounts, subject to board oversight. The adviser has the expertise for determining appropriate risk-based coverage amounts, and the board should be able to rely on that expertise as it relies on the adviser to make other decisions associated with the portfolio management and investment risk management functions.

The combination of a fund's compliance program, the proposed derivatives risk management program, and the proposed asset segregation approval requirement (with our proposed clarification) would provide a robust and sufficient independent check on the risk-based coverage amount

[22] Release, *supra* n. 2, at 156.

[23] *Id.*

determinations. First, compliance with rule 18f-4, including the asset segregation requirement, would be subject to compliance policies and procedures under rule 38a-1 and, thus, subject to administration by the CCO and oversight by the fund board. Second, the proposed derivatives risk management program, which would be adopted by those funds that make greater use of derivatives or use complex derivatives, would provide for derivatives risk management to be a separate function from portfolio management. Finally, the board's approval of asset segregation policies and procedures, and its oversight of the adviser's methodologies for determining risk-based coverage amounts, would involve the board at an appropriate oversight level where it can provide value to the process, on behalf of the fund's shareholders.

4. The Board's Oversight Role under the Proposed Derivatives Risk Management Program Needs Clarification

The Commission proposes to require funds that engage in more than a limited amount of derivatives transactions or that use certain complex derivatives transactions to adopt a derivatives risk management program. The proposal would require a fund to obtain initial approval of the program, and any material changes to the program, from the fund's board, including a majority of the independent directors. The fund would be required to designate an employee or officer of the fund or the adviser (who may not be the fund's portfolio manager) to be responsible for administering the program, whose designation must be approved by the board. The board would be required to review quarterly written reports from the designated person that describes the adequacy of the fund's program and the effectiveness of its implementation. A fund would not be required to adopt a program if the fund complies, and monitors its compliance, with a portfolio limitation under which the fund limits its aggregate exposure to derivatives transactions to no more than 50% of the value of the fund's net assets and does not enter into complex derivatives transactions.[24]

The Commission states that the board-approval requirement "is designed to facilitate scrutiny by the board of directors" in "an area where there may potentially be conflicts of interest between the investment adviser and the fund."[25] The Commission's conclusory statement is not supported by any further explanation. For the reasons discussed above, we do not believe that derivatives use presents a clear or significant conflict. We agree, however, that the board and the adviser should devote additional attention to a fund's use of derivatives when it makes a greater use of them or invests in complex

[24] Proposed rule 18f-4(a)(4). We note that the Release states that the rule would not require a fund to adopt a program "if the fund's *board* determines that the fund will comply, monitor its compliance with…" Release, *supra* n. 2, at 197 (emphasis supplied). This is not how we read the proposed rule text and request that the Commission clarify that the proposed rule requires that funds comply, and monitor compliance with, the conditions for being excepted from the derivatives risk management program requirement.

[25] Release, *supra* n. 2, at 226.

derivatives. We, therefore, support requiring those funds to adopt a derivatives risk management program, so long as the board's role in connection with the program is one of oversight.

In general, it appears that the Commission intends for the adviser to be responsible for managing the risks associated with derivatives investments, while the board retains oversight responsibilities, and we agree with this approach. For instance, the Release states that directors may satisfy their obligation with respect to the initial approval of the program "by reviewing summaries of the derivatives risk management program prepared by the fund's derivatives risk manager, legal counsel, or other persons," and that the summaries "might familiarize directors with the salient features of the program."[26]

Consistent with that apparent intent, we suggest that the Commission clarify the board's role regarding the policies and procedures that a fund must adopt.[27] The proposed rule states that the fund board would be responsible for approving the program (under subsection (a)(5)), but does not state that the board would be required to approve the policies and procedures that a fund must adopt under proposed subsection (a)(3)(i). The proposed policies and procedures would address portfolio management details that would not be appropriate for the board's oversight function. Under the proposal, the policies and procedures must be reasonably designed to assess and manage the risks associated with the fund's derivatives transactions, including potential leverage, market, counterparty, liquidity, and operational risks. The policies and procedures also would need to provide for: monitoring whether the fund's use of derivatives transactions is consistent with any investment guidelines, the relevant portfolio limitation, and relevant disclosures; informing portfolio management or the fund's board, as appropriate, regarding material risks arising from the fund's derivatives transactions; and periodically reviewing and updating the program at least annually, including any models, measurement tools, or policies and procedures that are part of the program to evaluate their effectiveness and reflect changes in risks over time.[28] We suggest that the board not be required to approve policies and procedures that address such details. Rather, the board could approve a program, which could provide that the adviser may establish the policies and procedures that address these details, subject to oversight by the board.

The Commission also appears to follow in some respects the framework for the fund compliance program rule. We suggest a few modifications to the proposed requirements, some of which are intended to make the proposed derivatives risk management program consistent with the fund compliance program framework and some of which are intended to reflect the important differences between the two programs.

[26] Release, *supra* n. 2, at 226-27.

[27] *See* proposed rule 18f-4(a)(3)(i).

[28] *See id*.

First, we recommend that the Commission eliminate the requirement that boards approve any material changes to the program. Under rule 38a-1, fund boards do not have to approve material changes to compliance policies and procedures; rather, the fund CCO's report to the board (which is required to be provided at least annually) must address any material changes to the policies and procedures since the date of the last report and any material changes recommended as a result of the annual review. The Commission does not provide a reason to depart from the rule 38a-1 framework in this regard. (The only reason the Commission gave is the following, rather circular, reason: "[T]he requirement to obtain approval of any material changes to the fund's derivatives risk management program from the board is designed to facilitate independent scrutiny of material changes to the derivatives risk management program by the board of directors.")[29] Consistent with the approach taken in rule 38a-1, we suggest that any material changes be included in an annual report to the board.

Second, we recommend some modifications regarding the role of the derivatives risk manager. We do not believe that the designation of the derivatives risk manager should be required to be approved by the board. The adviser, rather than the board, should approve the specific personnel serving in the role of the derivatives risk manager.[30] Requiring the board to approve the designation of specific personnel draws them too far into the management function. Instead, the board could approve a general description of the responsibilities of the derivatives risk manager as part of its approval of the program.[31] The proposal recognizes that the role of the derivatives risk manager is different than that of the CCO (whose designation, compensation, and removal must be approved by the board), and we believe it is important that this distinction be even clearer. Moreover, we do not believe that it is necessary for there to be a regulatory requirement that the derivatives risk manager report to the board. In some instances, but not necessarily all, the derivatives risk manager may provide reports to the board, but we are concerned about formalizing a reporting obligation of this type into a rule requirement. We believe that doing so unnecessarily interferes with the governance process and the board's discretion.

Finally, while we believe it is important for boards to receive reports regarding the derivatives risk management program, we recommend that the required frequency of the reports be at least annually, rather than quarterly, as proposed. The compliance program rule (and the proposed liquidity

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[29] Release, *supra* n. 2, at 227.

[30] We made a similar comment in our letter on the Commission's proposed Liquidity Risk Management Proposal. *See* Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, Secretary, SEC, regarding Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release; File Nos. S7-16-15 and S7-08-15 (January 13, 2016).

[31] Indeed, we recommend that a committee or group of persons at the adviser—and not just a single individual—be able to serve as the derivatives risk manager. Funds should have the flexibility to determine for themselves the appropriate structure for this function, and, in many instances, a group or committee of people with different perspectives (such as risk management, operations, legal, and accounting) may be a preferred structure.

risk management program rule) require similar reports to be provided to the board at least annually.[32] Of course, a board could in its discretion determine to receive these reports more frequently than annually. Moreover, to be consistent with the language used in rule 38a-1 under the 1940 Act, we suggest that the rule language state that the adviser must *provide* to the board the report (rather than that the board must *review* the report).[33]

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IDC supports the Commission's efforts in this proposal to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives. We urge the Commission to ensure that the board's role under any final derivatives rule remains one of oversight. We also request that the Commission be cognizant of the cumulative effect that each of its new regulations has on a fund board's overall set of responsibilities and to consider whether certain existing outdated rule requirements could be modified to enhance fund boards' overall effectiveness in protecting shareholders' interests.

If you have any questions about our comments, please contact Annette Capretta, Deputy Managing Director, at (202) 371-5436 or me at (202) 326-5824.

Sincerely,

Amy B.R. Lancellotta
Managing Director
Independent Directors Council

[32] *See* rule 38a-1(a)(4)(iii) under the 1940 Act and proposed rule 22e-4(b)(3)(ii), as proposed in Liquidity Risk Management Proposal, *supra* n. 4.

[33] *See* rule 38a-1(a)(4)(iii) under the 1940 Act. After consideration of these governance matters in connection with this proposal and to promote consistency with respect to the board's responsibilities, we believe the same adjustments should be made to the proposed liquidity risk management program. In particular, we recommend that: boards not be required to approve material changes to the liquidity risk management program, the liquidity risk manager not be required to report to the board, and that the adviser be required to *provide* reports to the board, rather than the board be required to *review* them. *See* Liquidity Risk Management Program, *supra* n. 4.

cc: The Honorable Mary Jo White, Chair
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

Mr. David Grim
Director, Division of Investment Management