MFDF

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

April 9, 2020

Ms. Vanessa Countryman
Secretary
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

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

Dear Ms. Countryman:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposal regarding the use of derivatives by registered investment companies.[2]

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides its members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

I Introduction

As we have written before, derivatives play an important role in the investment strategies of many funds, whether as an efficient means of implementing a traditional investment strategy, a

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1 The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

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, Release Nos. IA-5413 and IC-33704, 85 Fed. Reg. 4446 (Jan. 24, 2020) (hereinafter "Reproposing Release"). As a result of the challenges posed by the COVID-19 pandemic, we are submitting these comments after the expiration on the formal comment period in reliance on the Commission's recent statements that such comments will still be considered. *See* Statement (*available at* https://www.sec.gov/rules/proposed.shtml).

means of reducing portfolio risk or as a way of providing more innovative or more complex investment strategies for investors. Funds that utilize derivatives allow individual investors efficiently to access a wide variety of investment strategies and build portfolios suited to their individual goals and needs.

Because derivatives can be more complicated than ordinary securities, can change in value quickly and can potentially add leverage to funds' portfolios, they have drawn notable regulatory scrutiny over at least the past forty years. The Commission and its staff have issued rules and provided guidance to funds that use derivatives on numerous occasions, resulting in a complex and overlapping structure of regulation that can be difficult to compile, understand and administer. We therefore welcome the Commission's ongoing efforts to reconsider and harmonize its regulatory approach and believe that establishing a definite and consistent regulatory structure for derivatives will provide significant benefits to funds, boards and fund shareholders.

With respect to the substantive proposals, we are encouraged by the Commission's principles-based approach. We support the recognition that the derivatives risk management programs mandated by proposed rule 18f-4 for funds that are not limited users of derivatives should be correlated with the investment strategies and uses of derivatives employed by each fund that relies on the rule. We also support the requirement that funds relying on the rule that are limited derivatives users (and therefore not required to adopt derivatives risk management programs) be required to adopt policies and procedures reasonably designed to manage their derivatives risks. This flexible and principles-based approach should help ensure that efficient and innovative investment strategies remain available to the investors who rely on mutual funds while at the same time prompting advisers, funds and boards to engage in appropriate risk management activities related to those funds' derivatives exposures. Our letter focuses primarily on the role that the Commission would ask fund boards to play in overseeing funds' derivative risk management programs of the funds that will be required to have them and the overall use of derivatives by funds that rely on the new rule. Our comments on the board's role follow.

II. Derivatives Risk Management and the Role of Board Oversight

Broadly speaking, we are encouraged that the Commission is taking a more flexible, more principles-based approach to derivatives risk management than it did in its initial proposal of rule 18f-4. Most importantly, we believe that funds should have the ability to adopt derivatives risk management programs designed to manage the risk of the investment strategies and strategies for the use of derivatives that they actually employ. A fund's use of derivatives is closely connected to its investment strategy and the manner in which its adviser intends to use derivatives to help execute that strategy.

Because our members are fund independent directors, we focus on the role that the Commission envisions for the boards of funds that ultimately rely on the proposed rule. We start from the central premise that directors, as fiduciaries, provide oversight of the funds for which they are responsible on behalf of the investors in those funds. Notably, this means that fund directors cannot be and should not be directly responsible for the day-to-day management and operation of those funds, including the day-to-day operation of a fund's derivatives risk management program. In addition, in performing their oversight duties, directors should generally receive the protection of the business judgment rule, to protect their decisions from being second-guessed after-the-fact as long as they make informed judgments in good faith that they believe to be in the best interests of the fund and its shareholders.

Most fundamentally, we strongly support the Commission's recognition that proposed rule 18f-4 is subject to rule 38a-1 – a recognition that, in our view, better reflects the appropriate role of an independent fund board. As we said in our prior comment letter on this rule proposal:

> [I]t is worth stepping back and reflecting on the most fundamental roles that boards play in the investment management industry. Fund boards are fiduciaries. As fiduciaries, and under long-standing principles of regulation, a fund's board oversees its fund's performance, reviews the quality and cost of services obtained from the fund's adviser and other third-party service providers, and seeks to protect fund shareholders from the conflicts of interest that are inherent in asset management. Given this role, boards do oversee important topics such as fund management's risk management programs, but the board's role here has arisen historically out of its general fiduciary duty to the fund and its shareholders rather than from specific regulatory requirements.
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> The board's independent business judgment has traditionally been at the center of its oversight activities. Hence, boards have traditionally had significant leeway to structure their oversight of fund activities. [But when] the Commission mandates particular roles for boards and imposes new requirements on independent directors, it necessarily takes more control of the process…. [B]y imposing these duties directly, rather than making them subject to section 38(a) of the Act, the Commission [risks] suggesting that boards have a more direct role than just overseeing the fund's compliance…."[3]

Here, the Commission's express recognition that the rule would be subject to rule 38a-1 is a step forward in better delimiting the board's appropriate role. We view the specific activities that the Commission describes for fund boards through this prism. Specifically, the Commission has identified a number of core activities in which the board should engage:

- Approve the designation of a fund's derivatives risk manager;[4]
- Oversee and understand the derivatives risk management program;[5]

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3 Letter to Brent Fields, Secretary, United States Securities and Exchange Commission from David. B. Smith, Jr., General Counsel, Mutual Fund Directors Forum (Mar. 28, 2016) at 5-6 (*available at* https://www.mfdf.org/docs/default-source/default-document-library/publications/comment-letters/mfdfderivativesletter.pdf?sfvrsn=bc96e45e_6) (hereinafter "2016 Comment Letter").

4 *See* Reproposing Release, *supra* note 2, 85 Fed. Reg. at 4466-67.

5 *See id.* at 4466.

- Receive regular reports from the fund's derivatives risk manager covering the implementation and effectiveness of the derivatives risk management program;[6]
    - The above including the receipt of reports on the results of stress testing and VaR exceedances;[7]
- Receive reports on other material risks at the derivatives risk manager's discretion.[8]

We comment on each of these requirements below.

Approval of the Derivatives Risk Manager -- The proposed rule would require that a fund's board approve the designation of the fund's derivatives risk manager and that as part of its approval, it take account of the derivatives risk manager's "relevant experience regarding the management of derivatives risk."[9] We have some concern that the requirement that the board take into account the relevant experience of the designated derivatives risk manager could result in the board displacing the fund's adviser by assuming a direct role in personnel and structural issues. As a general matter, the adviser, not the board, should determine who within the adviser's organization performs key functions, including functions that are mandated by regulation. While boards may often have a role in probing and understanding an adviser's decisions around the organization and staffing of key functions, the adviser is in the best position to evaluate the appropriate experience of the derivatives risk manager.

We are, however, comforted by the flexibility that the Commission is providing boards around its action, particularly its indication that boards can consider what it and the adviser view as relevant experience rather than make determinations based on prescriptive criteria that might otherwise be in the rule. As with the Commission's approach to an individual fund's derivatives risk management program, this appears to suggest that boards can consider the types of experience that are relevant to the risks posed by the manner in which the individual funds that they oversee use derivatives rather than being required to adopt a one-size-fits-all approach.

Hence, we assume that in most cases, a fund board will review the relevant experience of the derivatives risk manager proposed by the fund's adviser (whether that manager is an individual or a group of people) and determine, in its business judgment and in light of the manager's relevant experience and risks posed by the fund's use of derivatives, whether to approve the designation. However, we also encourage the Commission strongly to affirm the adviser's fundamental role in defining and staffing the derivatives risk manager position, and reiterate that in most cases, the board should be able to rely, subject to its questioning of the adviser, on the adviser's assertion that the derivatives risk manager has the necessary and relevant experience. We further encourage

[6] *See id.* at 4467-68.

[7] *See id.* at 4468.

[8] *See id.* at 4464-65.

[9] *See id.* at 4466.

the Commission to recognize the important role that the board's business judgment plays in making this decision and indicate that it understands the need to avoid after the fact second-guessing of informed board judgments.

Oversight of the Derivatives Risk Management Program – We strongly concur that, as with all key areas of risk that a fund faces, a fund's board should be involved in overseeing the risks posed by the fund's use of derivatives and the manner in which those risks are identified, mitigated and managed. As we reiterated in a recent *Guidance* paper on risk oversight for fund directors, fund directors should have "an understanding of the most significant regulatory, investment and operational risks affecting a fund and a familiarity with the risk framework and processes implemented by the adviser to manage and mitigate those risks."[10] Applied to funds' use of derivatives, we have previously noted that "[w]e have . . . long taken the position that boards and independent trustees have an important role to play in overseeing the risks associated with funds' use of derivatives, including the manner in which those risks are managed."[11]

The Commission is thus correct to point to the board's role in overseeing a fund's derivatives risk management program. We further agree with the Commission that a board cannot satisfy its oversight responsibilities at a single point in time; rather, as the Commission characterizes it, board oversight is not a "passive activity" but rather is an "iterative process."[12]

As part of this process, boards will undoubtedly continue to do what they have been doing for many years while exercising their oversight of funds, including inquiring about and learning much about the risks a fund is taking and the steps that the adviser is taking to identify and manage those risks. As part of this, directors will also continue to develop their understanding not just about the adviser's derivatives risk management framework, but also reasonable detail about the specific derivatives in which the fund invests, why those derivatives are an efficient means of meeting the fund's investment goals, and the risks posed by individual derivatives as well as the fund's portfolio as a whole.

However, we are concerned about the potential of the rule potentially pushing directors too far into the process of understanding and overseeing every detail of a fund's derivatives risk management program. In that light, we are concerned with the Commission's statement that "directors should understand the program and the risks it is designed to manage."[13] Absent further context, it is unclear whether the Commission believes that boards need to be able to effectively probe and otherwise oversee the derivatives risk manager's conclusion that the derivatives risk management program is effective, or whether the Commission anticipates that directors will more deeply address the day-to-day operations of the program itself – a role that starts to look more like

10 *See* Mutual Fund Directors Forum, Role of the Mutual Fund Director in the Oversight of the Risk Management Function (Feb. 2017) at 2 (*available at* https://www.mfdf.org/docs/default-source/default-document-library/publications/white-papers/riskpaperfinal2017.pdf?sfvrsn=87916d4a_4).

11 *See* 2016 Comment Letter, *supra* note 3, at 2.

12 Reproposing Release, *supra* note 2, 85 Fed. Reg. at 4466.

13 *Id.*

a management function than an oversight function. As we suggest in our comments below, we urge the Commission to clarify that it understands the scope of a board's oversight role and that, as in other matters where the board exercises its fiduciary duties, the board's business judgment is protected.

***Annual Reporting on the Derivatives Risk Management Program* –** As proposed, the rule would require a fund's derivatives risk manager to report to the board in writing annually (and more often if so required by the board) on the effectiveness of the derivatives risk management program. Specifically, the derivatives risk manager would be required to inform the board whether the program is reasonably designed to manage the fund's derivatives risks and to incorporate the elements provided in the rule. As part of this report, the derivatives risk manager would also be required to provide the board with its analysis of the effectiveness of the fund's VaR model as well as of any exceedances in the fund's backtesting and stress testing of its derivatives positions.

We generally agree that this requirement is well-designed to allow the board to engage in informed oversight of the risks associated with a fund's use of derivatives and the manner in which those risks are being managed. We strongly agree with the Commission that the derivatives risk manager – and not the board – is in the best position to determine whether the derivatives risk management program is operating effectively. As we have stated above, boards do not have inherent expertise in risk management, and thus should not make these determinations themselves, but rather should oversee the determinations made by relevant professionals.

We thus believe that the board should also play a key role in designing how its oversight of the derivatives risk management program, and particularly its oversight of the derivatives risk manager's determination, should occur. Each board should have flexibility in determining how it wishes to do this. We therefore have some concerns about the proposed requirement that the board be furnished with such information "as may be reasonably necessary to evaluate the adequacy of the fund's program for reports following the program's initial implementation the effectiveness of its implementation."[14]

As the Commission emphasizes, the report is intended to enable the board to "appropriately exercise its oversight responsibilities, including its role under rule 38a-1."[15] Given that the proposed rule (equally appropriately) would not require that the board make these specific findings, we do not believe it makes sense to structure the reporting requirement in this matter, especially as it could lead to the conclusion that the board has at least an implied obligation to make these findings.

In addition, this open-ended information provision requirement risks overwhelming the board with unnecessarily detailed information and an implied assumption that the board has an in-depth understanding of this detailed information. Board members, who are generalists not specialists, should not be assumed or required to have the same level of detailed understanding of the day-to-day management of derivatives risk as does the derivatives risk manager.

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14 *Id.* at 4467.

15 *Id.*

We thus continue to believe that the board should largely be entitled to rely on the derivatives risk manager's representations as long as those representations are adequately supported in the written report that it provides and that the board, in its business judgment, believes that it has adequate information to test the derivatives risk manager's determination. Of course, the board would retain its usual ability to seek additional information from the adviser (or other third parties servicing the fund), and thus will be able to obtain any information it, in its business judgment, feels is necessary to oversee the derivatives risk manager's determination and otherwise provide appropriate oversight of the fund's activities. We accordingly recommend elimination of the cited information requirement for the derivatives risk manager's written report to the board.

Other information that the derivatives risk manager is required to provide to the board should be considered in this light. The VaR limits to which every fund relying on the rule would be subject, as well as the stress testing and backtesting of a fund's derivatives exposures, are critical to the operation of the rule. Hence, it is appropriate that the board understand, in at least summary form, the results of these tests and the circumstances in which the fund is outside of the exposure limits imposed by the rule. As the Commission notes, this information will often be necessary for the board's oversight of the derivatives risk management program as well as its oversight of how the fund responds when it is outside mandated risk limits. Moreover, we concur that it is critical that the information be provided to the board "in a format, and with appropriate context, that would facilitate the board's understanding of the information." However, we equally believe that the board should not be provided with overly detailed or technical information that might result in it micromanaging the derivatives risk management program rather than overseeing it. In order to ensure that this does not happen, we encourage the Commission not to mandate the manner in which the information is provided (nor the frequency with which it is provided), but rather rely on the discretion and expertise of the derivatives risk manager, combined with the judgment of the board, to determine how to report this information.

Reports on Material Risks – The Commission's proposal would also permit a fund's derivatives risk manager directly to report "material risks" of a fund's derivatives investments to the fund's board, presumably obviating the need to report risks through the fund's hierarchy and rely on other fund personnel to report the issues to the board.

We broadly support the ability of a fund's derivatives risk manager to communicate material risks directly to the fund's board. However, we have some concern over the untethered nature of this requirement. First, the rule relies entirely upon the derivatives risk manager's discretion to determine what constitutes a material risk. But more importantly, in contrast to the reporting obligation to the fund's portfolio managers which is based in part upon pre-identification of the "circumstances under which a fund must communicate with its portfolio management about the fund's derivatives risk management," what, when and how information must be reported is left entirely to the discretion of the derivatives risk manager.

In many cases, having some discretion about when and what to report to a fund's board will have advantages, especially when unexpected or unusually large risks become apparent. Hence, we would not encourage the Commission directly to attempt to define when the derivatives risk manager should communicate with the board. However, we believe that in designing the fund's policies and procedures, the board should work together with the derivatives risk manager to define the circumstances under which the manager would communicate an issue to the fund board. While this approach could leave room for the derivatives risk manager to exercise additional discretion to report unanticipated material risks to the fund's board, approaching the requirement in this manner will better enable the board to oversee the derivatives risk management process. After all, the board is unlikely to be in a position effectively to act on the reporting of a material risk; rather, in the case that any material risk arises, the board needs to be in a position to oversee the actions taken to mitigate or respond to the particular risk.

V. **Conclusion**

As described above, we believe that the Commission's reproposal of rule 18f-4 represents a step forward from its former approach. Not only does the rule better recognize the wide variety of ways that funds use derivatives by providing a more flexible principles-based approach to how funds manage derivatives risk, but most importantly, from the perspective of our members, it better defines the appropriate role of the board in the risk management process. That said, as we described above, we urge the Commission to describe the role of the board carefully, focusing on its oversight capabilities, rather than imposing obligations on the board that may force it into management of derivatives-related risks.

Again, we commend the Commission for undertaking to address this difficult but important proposal. We would welcome the opportunity to further discuss our comments with you. Please feel free to contact Susan Wyderko, the Forum's President, at 202-507-4490 or David Smith, our General Counsel, at 202-507-4491 at any time.

Sincerely,

David B. Smith, Jr.
General Counsel