November 7, 2011

Ms. Elizabeth M. Murphy
Secretary
United States Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940, File No. S7-33-11

Dear Ms. Murphy:

The Mutual Fund Directors Forum[1] ("the Forum") welcomes the opportunity to respond to the request for comments by the Securities and Exchange Commission ("Commission") on the Use of Derivatives by Investment Companies under the Investment Company Act of 1940.[2]

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing 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. A significant number of the Forum's members are responsible for overseeing funds that use derivatives and, therefore, they are highly interested in the outcome of the Commission's ongoing process to better understand how funds use derivatives and to analyze whether its regulation in this area needs to be updated or revised.

I. Introduction

Funds have used derivatives for a long time. Moreover, as the Commission's Concept Release indicates, the Commission and its staff have been involved in putting parameters around funds' use of derivatives since at least the late 1970s. In recent years, however, the use of

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1 The Forum's current membership includes over 650 independent directors, representing 98 independent director 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 *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Release No. IC-29776 (August 31, 2011) [76 FR 55237 (September 7, 2011)] (hereinafter "Concept Release").

derivatives has become more extensive and the complexity of those derivatives has increased. In addition, although the Commission and its staff have historically addressed some of the issues that arise when funds use derivatives, the Commission has not, as of yet, chosen to address the issue comprehensively or consider more broadly whether and how it should regulate funds' use of derivatives. We therefore agree with the Commission that this is an appropriate time to explore this issue and for the Commission to consider what, if any, further steps it should take in this area.

II. The Role of Directors

The Commission's Concept Release states: "A fund's use of derivatives presents challenges for its investment adviser and board of directors to ensure that the derivatives are employed in a manner that is consistent with the fund's investment objectives, policies and restrictions, its risk profile, and relevant regulatory requirements, including those under federal securities laws."[3] We agree with this statement, yet the issues raised in it – issues that bear deeply on how fund use of derivatives should be regulated – are otherwise not addressed in the Concept Release. We believe that in considering how to regulate funds' use of derivatives, the Commission should carefully consider whether the proposed regulations will make it more likely that derivatives will be used in a manner consistent with this model. As part of this analysis, the Commission should evaluate how any potential regulations will impact the ability of directors effectively to oversee their funds' use of derivatives.

As a general matter, we believe that funds are most likely to succeed in using derivatives as part of their investment strategy when (i) the use of derivatives is clearly contemplated by the fund's stated investment strategies and the derivatives actually acquired by the fund are appropriate tools for achieving the fund's investment objectives; (ii) the adviser understands and is fully capable of handling and managing the derivatives in which the fund invests, (iii) the adviser has adequately informed the fund's board on how the use of derivatives will impact the fund from both an operational and a risk management perspective; and (iv) the fund's board of directors can and does provide appropriate oversight of the fund's use of derivatives. It is when these conditions are met that investment in derivatives by a fund – no matter what type of derivative is involved – is most likely to benefit the fund's shareholders.

Fund directors, working together with fund management, play a critical role in making it more likely that fund shareholders will benefit from the fund's use of derivatives. As the ABA Committee on Federal Regulation of Securities stated in its recent report on funds' use of derivatives:

> As a general matter, directors should oversee fund derivatives in much the same way that they oversee other aspects of fund operations, including compliance with its investment objectives and policies generally. That is, fund managers are in the best position to establish policies and procedures designed to manage risk. Fund directors should be satisfied that those policies and procedures are reasonably designed to achieve their

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[3] Concept Release at 14.

objectives, and monitor the investment managers' adherence to those policies and procedures.[4]

Hence, directors' roles are always focused on providing oversight. From a regulatory perspective, however, their specific role can easily seem either undefined or ambiguous. Nonetheless, directors generally:

- Play a key role in establishing the investment objectives of a fund and overseeing a fund's performance, including in situations where the fund uses derivatives to achieve its investment objectives;

- Are often involved in reviewing what derivatives a fund may use, especially by reviewing management's analysis of the appropriateness of a particular type of derivative and the ability of the fund complex to handle the instrument from an operational standpoint;

- Oversee the fund manager's operational capabilities with respect to derivatives, including the fund's ability to perform the necessary accounting tasks and manage the legal and other documentation associated with derivatives;

- Oversee the fund manager's risk management process, including the ability of the adviser's risk management processes to identify and manage the risks of investing in derivatives;

- Have statutory obligations with respect to how derivatives that do not have a quoted market value are fair-valued by a fund (as is the case with respect to all securities that are not quoted in public markets); and

- Have a responsibility to oversee a fund's compliance with the securities laws, including any laws or regulations that affect the fund's ability to invest in derivatives.

We therefore believe that, as the Commission considers what approach it wishes to take with the future regulation of fund use of derivatives, it must keep in mind how any proposed approach to regulation meshes with the above model and how it will impact the obligations of directors. Directors benefit shareholders not by operating funds directly, but by overseeing conflicts and by helping ensure that more broad-based regulations are applied appropriately at the funds they oversee.[5] The SEC should take care that its proposals do not have the unintended

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4 Committee on Federal Regulation of Securities, ABA Section of Business Law, *Report of the Task Force on Investment Company Use of Derivatives and Leverage* (July 6, 2010) [hereinafter "ABA Report"] at 44..

5 As we said in our May 2008 letter on enhancing the effectiveness of Boards, independent directors "are able to respond flexibly and quickly to the specific issues faced by their funds" and this "allows for a flexible approach that stands in stark contrast to a 'one size fits all' regulating regime." Letter from Mutual Fund Directors Forum to Andrew J. Donohue, Director, Division of Investment Management (May 2, 2008), *available at* http://www.mfdf.org/images/uploads/newsroom/DirectorDutiesMFDFLetterMay22008.pdf.

consequence of undermining the place of directors in the regulatory structure. In particular, if a new system of regulation were to place directors in a position where they were encouraged to micromanage a fund's use of derivatives – or indeed required, implicitly or otherwise, to take a direct role in the management of a fund's derivative positions and their associated risks – then that system of regulation could result in placing a core management function in the hands of directors. Such a system would undermine directors' role as overseers, and would therefore be contrary to the best interests of fund shareholders.

III. Leverage and Asset Segregation

As the Commission's Concept Release recognizes, the use of derivatives can allow funds to gain a leveraged exposure to the reference assets that underlie those derivatives. A fund can also have significant liability exposures connected with a derivative position, particularly if that position does not perform as expected. Because the extent of these liabilities can far outweigh the initial investment in the instrument, the use of derivatives raises potentially serious concerns under the Investment Company Act of 1940, as amended (the "Act").

In order to respond to these policy concerns, the Commission and its staff have thus historically taken the position that section 18 of the Act, which generally prohibits an open-end investment company from issuing senior securities, can apply to funds' derivative positions. However, as outlined in the Concept Release, through one Commission release and a series of staff positions, the Commission and its staff have effectively created a body of law that permits funds to invest in derivatives that create leverage in their portfolios so long as they segregate a sufficient quantity of appropriate assets to cover certain of the losses those derivative exposures could create. In attempting to ensure that its approach in this area is comprehensive and consistent, the Concept Release thus asks numerous questions about how the Commission might implement its approach to segregation more formally. Many of these questions deal with the technical details of the approach, such as the situations in which the amount of assets to be segregated should be based on the notional value of the derivative and how, from an operational perspective, assets should actually be segregated.

The seeming need to ask this plethora of technical questions demonstrates the problems with implementing a detailed system of regulation that attempts to deal with the numerous types of derivatives in which funds may invest (in addition to new derivatives that may be introduced in the future), the investment objectives funds hope to achieve by investing in those derivatives, the different types of offsetting positions funds can establish, and the different ways of valuing both the derivatives and a fund's potential exposure once it has purchased a derivative. Derivatives and the derivatives market are complex and rapidly changing. The market is also characterized by the frequent introduction of variants on existing products and, at times, completely new products. Additionally, in recent years, funds have adopted more complex and more nuanced investment strategies, and thus are using derivatives – and sometimes the same type of derivative – in many different ways, including as a way of hedging and mitigating other risks present in fund portfolios.

Therefore, any detailed and purportedly all-inclusive approach to regulations governing funds' use of derivatives is almost necessarily destined to be out-of-date the moment it is issued.

A regulatory system of this type will lack the flexibility and responsiveness necessary to deal with this fast-changing environment.

We therefore agree with other commentators who have urged the Commission to adopt a principles-based approach. While we support mandated asset segregation in order to limit the amount of leverage funds can take on (and limit the extent to which funds can make purely speculative investments), we believe the adviser, subject to board oversight, should be responsible for determining the type of assets and the manner in which assets are segregated. Under this approach, funds, their managers and their boards will be able to customize their asset segregation policies based on all relevant factors, including: (i) the fund's specific investment strategy and associated risks; (ii) the types of derivatives in which the fund plans to invest; (iii) whether it makes more sense for the fund to base its segregation on the notional value of the underlying reference security, the mark-to-market value of the fund's obligation pursuant to the derivative or some other measure; and (iv) the types of assets the fund plans to segregate to offset the exposures and potential liabilities created by its derivative positions.

More specifically, we agree with the recommendations of the ABA Report that each fund that invests in derivatives should be required to adopt policies and procedures that direct, in the context of that fund's use of derivatives, the fund to segregate an appropriate amount of assets with respect to each type of derivative it uses. While the directors of the fund would not be responsible for developing these policies – as in other areas, doing so would be the responsibility of the fund's adviser – the directors would approve the policies and procedures. Directors' approval of the policies and procedures would be based on their conclusion, in the exercise of their business judgment, that the policies and procedures are appropriate. Directors would then also be responsible for overseeing compliance with these policies and procedures in the same manner that they oversee compliance with other fund policies and procedures and with the securities laws generally.

IV. Valuation of Derivatives

Directors play a key role in the valuation of fund assets – in particular, directors have ultimate responsibility for the fair valuation of fund assets that do not have a readily available market value. While fund boards of directors are ultimately responsible for fair valuing securities, boards can and do delegate the day-to-day responsibility for valuation to a fund's investment adviser based on robust valuation procedures approved by the fund's board.

Given the wide variety of derivatives as well as the differing uses of those instruments by funds, valuation issues (like the leverage and asset segregation issues discussed above) are best dealt with on a fund-by-fund basis. Prior to making an investment in a particular derivative, boards will need to assess whether the adviser has the capability to value the fund's derivative investments and perform the ongoing monitoring required to value the instruments. Once an initial decision to invest in a particular type of security is made, funds then look to their established valuation procedures for day-to-day valuation determinations.

Boards of directors approve funds' valuation policies and procedures. In addition, boards monitor the adviser's implementation of the policies and procedures. Appropriate oversight can help management and the board identify situations where potential changes to a fund's valuation policies or changes to a fund's investments may be necessary based on the adviser's capability to value an instrument on an ongoing basis. Establishing a robust valuation process can bring the adviser and fund board together to help ensure that a fund's securities are accurately valued, regardless of the complexity of a fund's investments. In this sense, valuing derivatives that lack a quoted market price is no different than valuing other types of unquoted and/or illiquid securities in which funds can and do invest. We therefore do not believe that valuation guidance specific to derivatives is necessary.

V. Approaches to Counterparty Risk

Managing counterparty risk is fundamental to successfully investing in derivatives. Not surprisingly, advisers to funds that use derivatives devote significant resources to managing counterparty risk and the boards of those funds put a similar effort into overseeing the adviser's risk management systems. In spite of the importance of this issue, however, the Act does not directly address counterparty risk in any obvious way.

Although the Commission appears to have an interest in addressing counterparty risk management, no provision of the Act clearly gives the Commission authority to regulate in this area. In the Concept Release, the Commission attempts to address counterparty risk by, in part, asking a number of questions about whether investing in derivatives in which a securities-related issuer is the counterparty implicates section 12(d)(3) of the Act – a provision that absent the exemption provided by rule 12d3-1, prohibits a registered fund from acquiring an interest in a security issued by a broker, dealer, underwriter or investment adviser.[6] But this discussion demonstrates the inherent limitations of using the Act to regulate the risks related to investments in derivatives. While the concepts underlying counterparty risk may parallel some of the concerns captured by the idea of "entrepreneurial risk,"[7] counterparty risk is a broader concept.[8]

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6 In discussing section 12(d)(3), the Commission points to the two policy concerns that underlie the prohibition: (i) that funds should not be exposed to the entrepreneurial risks of securities-related issuers and (ii) that investments in these securities could leave the fund vulnerable to abusive reciprocal practices. Only the first of these concerns is relevant to the question of counterparty risk. While the second of these concerns may be present in some circumstances, the board's overall responsibility for overseeing conflicts of interest is generally sufficient to protect fund shareholders from the risks of reciprocal practices.

7 As referenced in the Concept Release, "entrepreneurial risk" includes the risk that a fund may not be able to extricate itself from an illiquid investment in a securities related issuer. Concept Release at 57. As discussed in a 1984 Proposing Release, "[i]n 1940, securities related businesses, for the most part, were organized as private partnerships. By investing in such businesses, investment companies would expose their shareholders to potential losses which were not present in other types of investments; if the business failed, the investment company as a general partner would be held accountable for the partnership's liabilities; if the business floundered, the investment company would be locked into its investment." Concept Release at 57, citing *Exemption for Acquisition by Registered Investment Companies of Securities Issued by persons Engaged Directly or Indirectly in Securities Related Businesses*, Investment Company Act Release No. 13735 (Jan. 17, 1984) [49 FR 2912 (Jan. 24, 1984)].

8 In addition, while entities other than securities-related issuers rarely serve as counterparties for funds with respect to investments in OTC derivatives, to the extent that this can occur, section 12(d)(3) is underinclusive. The Commission might well look to other provisions of the Act to address this issue – for

For example, in attempting to manage counterparty risk, in addition to looking at the risks posed by specific counterparties, an investor will also look at the total exposure to a specific counterparty and the overall risks posed by a group of counterparties, among other possible factors.

Managing counterparty risk is thus both more complicated and more holistic than applying the limits established in rule 12d3-1 to fund investments in securities issued by securities-related issuers. We recognize that counterparty risk is not a theoretical issue, but rather a real risk that funds that invest in derivatives must face. A counterparty that fails to meet its obligations can have a negative impact on a fund than equals or exceeds an unexpected change in the value of the reference security. Funds and their advisers therefore must carefully analyze what exposures and risks they are willing to assume as part of the investment process.

Similarly, given the fundamental importance of counterparty risk to portfolio management, we understand that the Commission has an interest in addressing the issue and perhaps in providing the industry with further guidance. However, the counterparty risks faced by a particular fund – as well as the best method of managing those risks – will be specific to that fund and depend on the precise nature of the fund's investment objectives and its particular portfolio. For example, in identifying and managing its counterparty risk, a fund and its adviser may well wish to consider whether the derivative position is collateralized or whether the fund's exposure to a particular counterparty can be netted against an offsetting transaction with that counterparty. Neither of these potentially important factors are, for example, captured by the otherwise straightforward mathematical approach of rule 12d3-1.

Thus, while section 12(d)(3) may be the most apt provision for addressing this issue,[9] the Commission should act carefully to make sure that with whatever approach it takes (including in deciding whether to issue guidance, promulgate rules or take some other approach), it carefully and precisely identifies the potential problem it is trying to address. In addressing that issue, the Commission must adopt an approach that recognizes that a regulator has little ability to determine precisely how a fund should manage its counterparty risks, that a fund's adviser is in the best position to manage the specific counterparty risks its funds face, and that the board's role is, in the end, to oversee that risk management program. In particular, given the nuances inherent in managing counterparty risk, we discourage the Commission from adopting regulations limiting individual counterparty exposures that would impose a specific, defined approach on all funds, irrespective of their investment strategies, the particular derivatives they use and their specific approaches to risk management.[10]

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example, sections 5(b, 8(b) and 13(a) – but as others have noted, these provisions have their own limitations. *See, e.g.*, ABA Report at 27-28.

9 Given the breadth and importance of this issue, the Commission may also wish to consider the extent to which the approaches to diversification and portfolio concentration in sections 8(b) and 13(a) of the Act augment its ability to address this issue.

10 Hence, while section 12(d)(3) arguably applies to investments in derivatives in which a securities-related issuer is the counterparty, rule 12d3-1, as currently written, is not an especially helpful way of addressing counterparty risk.

We are pleased that the Commission plans further consultations with stakeholders and experts on these important issues before proposing further action. We would welcome the opportunity to be a part of those discussions, and to further discuss not just our comments, but how independent directors can continue to play a role in ensuring a healthy and robust fund industry. Please feel free to contact me or Susan Wyderko, Executive Director of the Forum, at 202-507-4488.

Sincerely,

David B Smith, Jr.
Executive Vice President and General Counsel

cc: The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
The Honorable Troy A. Paredes
The Honorable Daniel M. Gallagher
Eileen Rominger, Director, Division of Investment Management