MUTUAL FUND DIRECTORS FORUM
The FORUM *for* FUND INDEPENDENT DIRECTORS

March 28, 2016

Mr. Brent J. Fields
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 Mr. Fields:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the Commission's recent rule proposals 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.

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I Introduction

In recent years, derivatives have become an increasingly important part of many funds' investment strategies, whether as an efficient means of implementing a traditional investment

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, Release No. IC-31933 (File No. S7-24-15), 80 Fed. Reg. 80884 (Dec. 28, 2015) (the "Release").

strategy, a means of reducing portfolio risk or as a way of providing more innovative investment strategies for investors. Derivatives thus play a crucial role in allowing individual investors efficiently to access a wide variety of investment strategies through investments in mutual funds that employ them. However, because derivatives are more complicated than other more ordinary securities, can seemingly add leverage to funds' portfolios, and can change in value rapidly, it is not surprising that they have drawn regulatory attention.

Most broadly, while we support the certainty that establishing a definite regulatory structure for derivatives would provide to funds, boards, and fund shareholders, we are concerned that the Commission's approach to derivatives is overly detailed, highly complex, potentially expensive, and risks impairing the ongoing innovation and efficiency enhancements that ultimately benefit fund shareholders.

Our comment letter, however, focuses largely on the role that the Commission's proposal would ask fund boards to play rather than on the specifics of the regulatory regime that the Commission is proposing. We certainly agree with the Commission that fund boards should oversee the efforts of fund advisers to manage the risks that investment in derivatives entails. In spite of that agreement, we are concerned that the Commission's description of the board's role goes beyond a board's oversight responsibilities, and, instead, forces the board to become involved in risk management. In addition, and perhaps even more importantly, given other recent regulatory initiatives, we are troubled by both the overall burden that the Commission is imposing on fund boards and the pace of change that these initiatives would require. We outline these concerns in greater detail below.

II. Derivatives Risk Management and the Role of Board Oversight

We agree that establishing a stable and definite regulatory framework within which funds can invest in derivatives is an important goal and appreciate the Commission's efforts to provide this framework. While we agree with the overall goal, we are concerned about the requirements that the Commission would place on the boards of funds that invest in derivatives.

A. The Role of The Board

Derivatives are securities and generally should be treated like other securities by managers and boards. That said, derivatives can pose different types of investment and operational risk than other types of securities in which funds invest. We have thus 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. As we said in our comments on the Commission's Derivatives Concept Release, "funds are most likely to succeed in using derivatives as part of their investment strategy when," among other things, "the fund's board of directors can and does provide appropriate oversight of

the fund's use of derivatives."[3] We also explicitly recognized that a board should "[o]versee 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."[4]

Recognizing the importance of the board's role, we have also focused in recent years on providing directors with the education and information they need to effectively oversee funds' use of derivatives and published guidance addressing both the oversight of alternative fund strategies and the risks associated with derivatives investing. Most notably, we published reports in both 2010[5] and 2014[6] that were directed, in part, to assisting directors in developing approaches to overseeing funds that use alternative strategies, derivatives and other complex securities.

We, therefore, agree that to the extent that investment in derivatives results in different types of risks, those risks should be identified and appropriately managed. In addition, we fully agree with the Commission that directors can and should play an important role in overseeing how the risks associated with derivatives use are managed. However, it is critical to emphasize that the board's role is one of oversight, not one of direct management of the risks. As with other recent Commission initiatives, the Release states that the board can limit itself to overseeing the risk management program, that it can rely on summary reports from employees within fund management who do manage the risks to fulfill its role, and that the board does not need to have a deep or granular understanding of every derivative that the fund does or might use. We support these characterizations of the board's important but limited role.

That said, the proposed rule would require funds to have highly detailed and prescriptive rules governing their use and management of derivatives. Requiring boards to approve the policies and procedures by which these rules are implemented will almost necessarily require that boards develop a detailed understanding of the procedures and risks causing the board to micromanage a fund's approach to its derivatives investments. In addition, no matter how the Commission describes the role of the board in a release, it is often easy to conclude that a board should have examined a topic in greater depth, should have questioned management more aggressively or should have taken different steps to address and mitigate a particular risk.

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3 *See* Letter to Elizabeth M. Murphy, Secretary, United States Securities and Exchange Commission from David B. Smith, Jr., General Counsel, Mutual Fund Directors Forum (Nov. 7, 2011) at 2 (*available at* http://mfdf.org/article-detail/16-comment-letters/forum-comment-letter-on-the-sec-concept-release-on-fund-use-of-derivatives).

4 *Id.* at 3.

5 *See* Mutual Fund Directors Forum, *Risk Principles for Fund Directors: Practical Guidance for Fund Directors on Effective Risk Management Oversight* (Apr. 2010) (*available at* http://mfdf.org/article-detail/17-reports/forum-report-risk-principles-for-fund-directors).

6 *See* Mutual Fund Directors Forum, *Board Oversight of Alternative Investments* (Jan. 2014) (*available at* http://mfdf.org/article-detail/17-reports/board-oversight-of-alternative-investments).

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By way of example, many of the Commission's proposals seemingly put the board in the position of needing to go far beyond summary reports. For example, the proposals might be interpreted as requiring boards to build a detailed knowledge of VaR and many other highly technical investment concepts in order to approve the appropriate exposure limits for their funds. Numerous other aspects of the Commission's proposal might similarly be read to imply that boards will obtain a high degree of technical knowledge. The requirement to review quarterly reports on the effectiveness of a fund's risk management program may have the same effect – if the Commission is going to require a fund to review a topic this frequently, isn't it also assuming the boards will develop a detailed understanding of the topic rather than just relying on summary reports?

As we said in the context of the Commission's liquidity risk management proposal, "the Commission and others must consistently be mindful of the board's oversight role and not expand the role of directors in a manner that makes them responsible for directly managing risk or that judges the performance of the board or the risk management program it oversees in hindsight." No risk management program can ever accurately forecast how markets or individual securities will react in all circumstances.[7] As a result, we believe that the Commission should make clear that when a board is appropriately informed regarding a fund's use of derivatives and its derivatives risk management program, the board can use its business judgment to determine whether it is satisfied with management's approach, and that its judgment will not be second-guessed.

We also urge the Commission to reconsider the extent to which the board's role, from a purely regulatory perspective, should be characterized more in terms of overseeing the fund's compliance with the securities laws under section 38(a). While the Commission attempts to justify imposing a direct oversight obligation on boards by asserting that a conflict between the adviser and the fund potentially exists in the use of derivatives, the Release contains little analysis of what this conflict might be. Indeed, it is difficult to see why whatever conflict exists would be any different from that which exists in connection with any investment a fund might make. We are therefore unconvinced that such a conflict exists in most circumstances. This is not to say that the board has no role in the oversight of the fund's risk management programs; in virtually all cases, it will. The board, however, should be able to rely on its own business judgment to structure its oversight rather than by structuring its oversight as an attempt to comply with a regulatory mandate.

B. The Board's Role in Context

As outlined above, viewed in isolation, the Commission rule proposal does address an area that directors should appropriately oversee. However, the Commission's proposal does risk involving boards in risk management and even in the day-to-day details of the operation of the

[7] This is especially true given that derivatives are often used to achieve an investment goal, and that, as with any other investment, derivatives can react unpredictably to market conditions and certainly can go down in value. Indeed, a risk management program should not be designed with the overarching goal of protecting fund investors from investment loss.

risk management program, at an inappropriate level of detail. Even more importantly, viewed in the context of other recent regulatory initiatives, the proposal heightens our growing concern that the Commission, perhaps unintentionally, is altering the role of the board, impacting the culture of the boardroom and changing the relationship between the board, fund management, regulators, and fund shareholders. We question whether this transformation will be beneficial for fund shareholders, or for the industry as a whole.

Over the past few years, the Commission has increased its expectations of boards, expanded existing board obligations and initiated the process of imposing new responsibilities on boards. Among other things, the Commission and its staff have pushed boards to engage in the valuation process at a greater level of detail,[8] clarified and expanded the level of detail with which boards must review distribution-related expenses and activities,[9] focused boards on the importance of cybersecurity in fund operations[10] and proposed a new role for boards in the oversight of funds' liquidity risk management programs.[11] The current proposal would similarly impose oversight requirements on boards of funds that make any significant use of derivatives. We also understand that the Commission is pursuing further regulatory initiatives, including increasing the role of stress testing in the industry and imposing requirements around adviser transition planning, each of which may well also impose further requirements on fund boards.

At one level, these are not new areas for fund boards. Boards, acting on behalf of fund shareholders, have always sought effectively to oversee the manner in which the fund's adviser operates the fund, identifies the risks the fund faces, and seeks to mitigate those risks. For example, as we have noted above, boards always have taken a role in overseeing risk management programs at the funds they oversee.

As the Commission and the staff continue to consider imposing specific requirements on fund boards, however, it 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 board oversees its fund's performance,

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8 *See, e.g.,* Final Rules, Money Market Fund Reform, Release Nos. 33-9616, IA-3879 & IC-31166, 79 Fed. Reg. 47736, 47814 (suggesting that boards need to consider a pricing service's "inputs, methods, models and assumptions.") The Commission staff did later state that that this release did not represent a change in existing law and that boards could continue to delegate these activities subject to appropriate oversight. *See* Division of Investment Management, "Valuation Guidance Frequently Asked Questions" (Apr. 23, 2015) (*available at* http://www.sec.gov/divisions/investment/guidance/valuation-guidance-frequently-asked-questions.shtml). However, many have assumed that the language in the Money Market Fund Reform Release has had the effect of increasing both the amount and the specificity of boards' involvement in the valuation process.

9 *See* Division of Investment Management Guidance Update 2016-01: Mutual Fund Distribution and Sub-Accounting Fees (January 2016) (*available at* www.sec.gov/investment/im-guidance-2016-01.pdf).

10 *See* Division of Investment Management Guidance Update 2015-02: Cybersecurity Guidance (Apr. 2015) (*available at* www.sec.gov/investment/im-guidance-2015-02.pdf).

11 *See* Proposed Rules, Open-End Fund Liquidity Risk Management Programs, Release Nos. 33-9922 & IC-31835, 80 Fed. Reg. 62274, 62323-25 (Oct. 15, 2015).

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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.

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 as the Commission mandates particular roles for boards and imposes new requirements on independent directors, it necessarily takes more control of the process, determining what matters the board must consider (and sometimes when or how often it must consider those matters). Moreover, by imposing these duties directly, rather than making them subject to section 38(a) of the Act, the Commission appears to be suggesting that boards have a more direct role than just overseeing the fund's compliance with applicable laws and regulations. We worry that this shift will have a number of potential consequences. For example:

- Will the proposed rules and the specific requirements of board review constrain a board's ability to set its own agenda and to focus on the issues that it believes are most important and most likely to impact fund shareholders?

- Do the proposed requirements incent the board to focus on details and risk drawing the board's attention away from broader issues of the quality and effectiveness of fund management?

- To what extent will the increased time that Boards have to devote to new mandates detract from other core board activities?

- Will the proposed requirements that boards approve the designation of specific types of risk managers detract from the ability of the board to use its discretion to structure its relationship with fund management in the way it determines, in its business judgment, is most appropriate? Will these requirements potentially damage the relationship between the board and management in unintended ways?

- To what extent will boards feel pressure to bring on new directors with specific skillsets (e.g., experts in derivatives, cybersecurity and so forth) at the expense of directors with general business and investment expertise who can exercise their business judgment with respect to a wide range of issues?

The answers to these questions are neither obvious nor easy. But as regulatory initiatives continue to impose new, time-consuming, and seemingly substantive requirements directly on boards, we need to ask questions that go beyond whether boards should or can oversee management's response to specific individual regulations, and instead assess whether the combined weight of the Commission's recent actions will change the culture and effectiveness of boards in ways that may be detrimental to the fund shareholders they represent.

We welcome recent comments by SEC officials that emphasize that boards should generally act only in an oversight capacity – for example, we agree with Division Director Grim's recent comments that "[o]versight' does not equal day-to-day management of a fund"

and "if directors are overly burdened with a management function, they can't effectively serve in their intended capacity."[12] However, speeches are not enough. Moreover, given the breadth of the issues we outline above, it is difficult, if not impossible, to address these questions in the context of a single rulemaking initiative. But given the fundamental importance of the board's role, these questions must be asked. It is in no one's interest – not fund shareholders', not the industry's, and not the Commission's – to fundamentally change the role and culture of boards without careful thought or to unintentionally impair the effectiveness of boards or undermine the fundamental role they play in regulatory system. We strongly encourage the Commission to step back and consider these critical questions not just in this rulemaking, but in all its current regulatory initiatives that impact boards.

III. Impact on Innovation and Investors

We also have concerns about the manner in which the proposed rules, if adopted, will affect both existing funds and future innovation in the industry. As the Commission itself concedes in the Release, some existing funds do not currently and will be unable to comply with the restrictions the proposed rules would place on the amount of derivatives a fund could hold in its portfolio. While the Commission asserts that this number is relatively low, we are aware that other commenters will provide data suggesting the number is much higher. Thus, the impact of the limits the Commission would place on funds' ownership of derivatives may be much larger than the Commission currently estimates.

More importantly, we do not believe that the Commission has demonstrated that this type of restriction is necessary. While the use of derivatives can add risk to a fund's portfolio, the mere risk of a loss in the value of the derivatives position is not a sufficient reason to place limits on derivatives ownership that do not currently exist. Investment, after all, appropriately carries a risk of loss; the important question is whether investors are aware of the investment strategy employed by a fund, the risks inherent in that strategy, and the manner in which the use of derivatives either increases or mitigates that risk.

Placing new limits on the ownership of derivatives might be justified if there was a notable history of registered funds experiencing substantial, unpredictable losses as a result of their use of derivatives. However, there are very few examples of this occurring.[13] Moreover,

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[12] *See* David Grim, Director, Division of Investment Management, Remarks to the PLI Investment Management Institute (Mar. 3, 2016) (*available at* https://www.sec.gov/news/speech/remarks-to-pli-investment-management-institute-2016.html).

[13] The Commission identifies in the Release a small number of cases in which registered funds experienced significant losses as a result of their use of derivatives. *See* Release, *supra* note 2, at nn. 123-126 & accompanying text. However, each of these cases involved violations of the disclosure requirements of the securities laws. In sum, there are many investment strategies that can result in losses – sometimes substantial losses – but this fact is not, in and of itself, sufficient to prohibit a fund from engaging in a particular strategy or to prohibit an investor from including that strategy in his or her portfolio. While we recognize that there are likely some outlier strategies that should not be executed through a registered fund, we believe that in many cases -- particularly cases where many funds that make significant use of derivatives have operated effectively – the Commission should focus on whether a fund and its adviser are properly identifying and managing risks and whether those risks are appropriately disclosed.

given the increased focus on risk management programs, including the programs that would, ultimately, be mandated as a result of both this rulemaking process and the liquidity risk management proposal, that risk should be lessened even further. Given this, we do not believe that the Commission has provided sufficient justification for further restricting current practice.

We are also skeptical of the Commission's reliance on the anti-speculation provisions of the Act to justify its position. While some of the investment strategies that could be barred by the Commission's proposed approach may appear to be speculative when viewed in isolation, approaches to investing and portfolio construction have evolved substantially since the Act was adopted in 1940. In particular, funds that may appear speculative often have a role in the construction of broader portfolios. Therefore, we believe that the Commission should be very careful about limiting the ability of investors and their advisers to use such funds in the absence of clear evidence that the funds pose an unacceptable level of undisclosed risk.

Additionally, we do not feel that the Commission has identified good reasons to eliminate leveraged ETFs and other ETFs that make substantial use of derivatives, particularly where those ETFs have a record of operating soundly and successfully. ETFs are unique products that operate differently, are bought, sold and traded differently than more traditional funds, and are used for different purposes than those funds. Leveraged return ETFs have operated successfully for the past decade, and indeed the operational differences between these ETFs and open-end funds may mitigate risks that would otherwise exist. At any rate, the Commission fails to address this possibility in a detailed and analytic way. In addition, while leveraged return ETFs may permit investors to engage in a degree of speculation, all investments have speculative aspects and the Commission offers no analysis as to why these funds are unduly speculative as opposed to appropriately speculative.

In recent years, often through the use of derivatives, the fund industry has developed new strategies that allow investors to address their individual needs beyond more traditional long equity strategies. We believe that the Commission should act carefully and with strong justifications before constraining the industry's ability to innovate on behalf of investors. Up to now, the Commission has not offered compelling reasons to restrict or prohibit existing investment practices in the fund industry.

IV. Conclusion

In conclusion, we recognize the value of adding certainty and consistency to the treatment of fund investments in derivatives under the Investment Company Act. We also recognize that fund boards can and should oversee funds' use of derivatives and their concomitant risks. But the Commission's approach in its proposal raises serious concerns. In particular, we believe that the proposal risks both unnecessarily involving boards directly in risk management functions and, when viewed together with other regulatory initiatives, risks both overburdening boards and changing the boardroom dynamic in an unhelpful way. Finally, from a substantive perspective, we are concerned that the Commission's proposal will limit innovation

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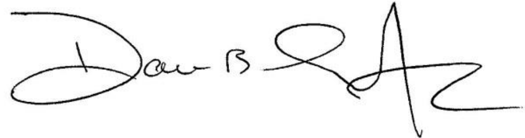
in the fund industry and thereby unnecessarily restrict individual investors' access to effective and efficient investment strategies.

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