

June 22, 2016

Mr. Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, D.C. 20549-1090

Re: Supplemental Comments on Liquidity Risk Management and Funds' Use of  
Derivatives Proposals; File Nos. S7-16-15 and S7-24-15

Dear Mr. Fields:

The Independent Directors Council<sup>1</sup> appreciates the opportunity to provide this supplement to our comment letters<sup>2</sup> on the Commission's proposals regarding liquidity risk management programs and funds' use of derivatives.<sup>3</sup> Both proposals raise important issues concerning the appropriate oversight role of fund boards. Indeed, the proposals bring us to a critical juncture in the ongoing

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<sup>1</sup> 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 \$17.8 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.

<sup>2</sup> See Letter from Amy B.R. Lancellotta, Managing Director, IDC, to Brent J. Fields, Secretary, SEC, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies; File No. S7-24-15 (March 28, 2016) and 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).

<sup>3</sup> See Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933, (December 11, 2015) and 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).

discussion regarding the SEC's expectations of independent directors and the types of responsibilities that are appropriate to impose on them.

We agree with Chair White's assessment that determining the appropriate dividing line between oversight and management "is a challenge" and appreciate that it is "one that the SEC is grappling with" as it considers the proposed reforms.<sup>4</sup> The issue is broader than the proposed reforms, however. Commission staff commentary and enforcement cases also have raised concerns about the widening gap between the Commission's and the industry's views regarding the appropriate role of independent directors.<sup>5</sup>

To underscore the points we made in our comment letters and to further the important dialogue on this subject, we provide below our views on the appropriate oversight role of fund directors and where directors add value on behalf of fund shareholders. In addition, we urge the Commission to hold a roundtable on fund governance at which Commission members and staff, independent directors, board counsel, and other interested parties can engage in a fulsome discussion of this important subject. Since the Commission's successful roundtable on the "independence" of fund directors nearly 20 years ago, the industry has continued to grow and become more complex, directors' responsibilities have continued to expand, and the fund compliance program rule has strengthened the oversight framework of all funds within the industry. A robust discussion regarding appropriate fund director responsibilities would enlighten us all and help promote a common understanding of how fund directors can be most effective in representing shareholders' interests.

### **Fund Directors' Oversight Role is Based on Federal and State Law**

Federal and state law recognize that the role of fund directors is to represent the interests of fund shareholders through independent oversight and not through day-to-day management of the fund or micromanagement of the fund's adviser. The Investment Company Act of 1940 imposes specific

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<sup>4</sup> See SEC Chair Mary Jo White, "The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference" (March 29, 2016) ("White 2016 Speech").

<sup>5</sup> See, e.g., White 2016 Speech, *supra* n. 4; and SEC Chair Mary Jo White, "Remarks at Securities Enforcement Forum" (October 9, 2013) ("White 2013 Speech") (referring to directors as "gatekeepers"); see also Greg Saitz, "No Excuses in Fight for Broker Information: SEC Official," *BoardIQ* (March 22, 2016) (quoting a Commission staff member regarding board oversight of intermediaries that, "I can't get the information' is not a valid excuse. . . there is no carveout in the federal securities law for. . . they won't give it to me"); 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) ("Fink and Edwards") (recent rule proposals constitute "a major departure from independent directors' traditional focus on conflicts of interest"); Letter from David M. Lynn, Chair, Federal Regulation of Securities Committee, ABA Business Law Section, to Brent J. Fields, Secretary, SEC, regarding Use of Derivatives by Registered Investment Companies and Business Development Companies; File No. S7-24-15 (April 8, 2016) (the committee "remains concerned that the Commission is seeking to move the traditional role of the Fund Board from oversight, and in particular, oversight of conflicts of interest, closer to an investment management role.").

responsibilities on fund directors that are designed primarily to protect against potential conflicts of interest between the adviser and the fund.<sup>6</sup> Historically, Commission rules sought to have independent directors concentrate on situations where there are those types of potential conflicts of interest.<sup>7</sup> The responsibilities imposed on directors under the federal securities laws are in addition to the fiduciary duties of loyalty and care imposed by state law.<sup>8</sup> The business judgment rule under state law generally protects independent directors from personal liability where they have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the fund.

### **Fund Directors are Most Effective as Independent Overseers**

The legal framework's treatment of fund directors as independent overseers is sensible. Directors are most effective in representing shareholders' interests when they can provide an independent perspective regarding management's activities and can focus on matters most important to shareholders' interests, without being distracted by the detail of day-to-day management activities. In other words, independent oversight helps directors focus on what is important for shareholders and not lose sight of the forest for the trees.

The effectiveness of fund directors is a product of not only their independence, but also of the knowledge they develop through their sustained and ongoing oversight of numerous aspects of fund operation and management. In order to reach informed decisions, directors devote substantial time and consider large amounts of information related to various aspects of fund operation and management. Perhaps even more importantly, they engage in an active discussion with management and ask probing questions about, among other things, the fund's investment performance and whether management has sufficient resources, including experienced and qualified people, dedicated to the fund and robust processes for managing the fund's investments and operations. They also receive information and inquire about areas, such as those suggested by Chair White, to ensure that the fund's adviser is appropriately managing certain risks, including liquidity risk and cybersecurity risk.<sup>9</sup>

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<sup>6</sup> The 1940 Act's legislative history makes clear that the primary role of independent directors is to oversee conflicts of interest between the fund and the adviser. See Amy B.R. Lancellotta, Paulita A. Pike, and Paul Schott Stevens, *Fund Governance: A Successful, Evolving Model*, 10 Va. Law & Bus. Rev. 3 (Spring 2016) (discussing the evolution of fund governance under the 1940 Act); see also *Burks v. Lasker*, 441 U.S. 471, 484-85 (1979) (stating that Congress entrusted to fund independent directors "the primary responsibility for looking after the interests of the funds' shareholders" and that the 1940 Act is designed to place independent fund directors in the role of "independent watchdogs").

<sup>7</sup> See Fink and Edwards, *supra* n. 5.

<sup>8</sup> The duty of loyalty requires directors to act in good faith and in the best interests of the fund, rather than in their private interests. The duty of care requires directors to act with reasonable care and skill in light of their actual knowledge and any knowledge they should have obtained in functioning as directors.

<sup>9</sup> See White 2016 Speech, *supra* n. 4.

Independent oversight does not require directors to be experts in matters relating to the funds, particularly those that are more appropriately in the purview of fund management. Indeed, decision-making regarding daily management matters is not where fund directors can add value. Boards are on site for meetings periodically (*e.g.*, 4 to 5 times) throughout the year; they are not on the ground, engaged in day-to-day functions and with daily access to the types of information necessary for appropriate management activities. Thus, they do not know, and cannot be expected to know, the level of detail that management personnel acquire through their daily activities.

In exercising their oversight function, directors rely on information provided by management and others, such as the fund's chief compliance officer, who have a deeper level of involvement in day-to-day activities, and board counsel, which has relevant expertise and a breadth of knowledge regarding governance and other practices. In addition, as the Commission itself has acknowledged, boards can hire experts to assist them on specific subjects; directors do not need to become experts themselves on those subjects.

### **Factors to Consider Regarding Appropriate Oversight Responsibilities**

Although there is broad agreement that the board's role is one of oversight, recent developments indicate that there may be different views regarding what "oversight" means and, thus, the types of responsibilities that can appropriately be imposed on independent directors—and those that would inappropriately draw them into management functions. We suggest below some factors that may assist in this consideration.

#### *1. Potential conflict of interest*

Traditionally, the Commission has determined to impose specific responsibilities on independent directors when a matter involves a potential conflict of interest between the interests of the fund and those of the adviser.<sup>10</sup> We agree with this approach, which is consistent with the very reason the 1940 Act created a role for independent directors.<sup>11</sup> The Commission's recent rule proposals, however, seem to be a departure from this historical construct. As we stated in our initial comment letters, liquidity risk management and funds' use of derivatives do not present conflicts of interest that warrant independent scrutiny by a fund board.<sup>12</sup> While less liquid securities and certain derivatives can present additional investment risk and are the subject of certain regulatory provisions, a

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<sup>10</sup> See Division of Investment Management, US Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) at 266.

<sup>11</sup> See, *e.g.*, Section 1 of the 1940 Act (it is the policy and purposes of the 1940 Act to mitigate, among other things, conflicts of interest).

<sup>12</sup> Fulfilling an oversight responsibility as part of a general fiduciary duty is markedly different than meeting a detailed specific regulatory obligation designed to protect against potential conflicts of interest (such as approving cross-trades under Rule 17a-7 under the 1940 Act) and, as such, could implicate different levels of responsibility for fund directors.

fund's investment in these instruments does not present a conflict of interest. Indeed, the interests of a fund's adviser and the fund (and the board) generally are aligned when it comes to liquidity risk management and use of derivatives, because they all want the fund to be able to meet redemption requests and to utilize a range of investment opportunities, including derivatives as appropriate, to enhance the shareholder experience by improving returns and/or reducing risk.

## 2. *Fund compliance program*

Any new regulatory requirement would be subject to the robust compliance oversight framework required by rule 38a-1 under the 1940 Act. Before the Commission seeks to impose specific approval responsibilities on fund directors, it should consider the extent to which a fund's compliance program would address any regulatory concerns. Because the regulatory requirements for a liquidity risk management program and a funds' use of derivatives would be subject to the rule 38a-1 framework overseen by boards through the CCO, we question why the rule proposals seek to impose specific approval responsibilities on directors. Moreover, the proposals introduce considerable uncertainty regarding how the liquidity risk management and derivatives programs relate to the compliance program.

## 3. *Director expertise*

Regulations that effectively require fund directors to develop deep expertise on a subject are inconsistent with the conventional understanding of an oversight role. The two proposals at issue here raise concerns that directors would be expected to have, or to develop, in-depth understanding of technical matters such as factors for determining a three-day liquid asset minimum, value-at-risk models, or the computation of risk-based coverage amounts for complex derivatives. Such an expectation suggests that the proposed regulatory responsibilities would be inappropriate to impose on fund directors.

## **There are Serious Consequences to Not Drawing the Oversight-versus-Management Line Correctly**

Any shift in a board's responsibilities from its traditional oversight role toward management functions could lead to several negative consequences, to the detriment of effective fund governance. First, because directors cannot be everywhere on every issue, any expectation that directors should make the kinds of decisions typically made by on-the-ground management personnel would seem to set directors up for failure.<sup>13</sup> It raises questions and concerns about whether such expectations expose directors to increased liability. Directors may come to believe that they need to dive deeply into the subjects to be able to make informed decisions about fairly technical matters. Such deep dives could

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<sup>13</sup> See, e.g., Chris Flood, "Independent fund directors rattled by change in role," *FT.com* (May 15, 2016).

distract them from offering an independent perspective on that and other matters. The perception of potentially increased liability could deter otherwise qualified individuals from serving on fund boards.

Second, imposing management responsibilities on directors could alter the composition and dynamic of fund boards in a way that would reduce their effectiveness. For example, such requirements could lead boards to determine that they need to have members with specific subject-matter expertise (*e.g.*, derivatives, cybersecurity), but an overemphasis on expertise could result in a less effective, cohesive, and collegial board; an over-reliance on individual experts for decision-making, rather than the board as a group; and a limited pool of qualified candidates. An over-emphasis on subject-matter expertise also could lead to less attention on the many other matters on which boards must focus. In addition, given the rapidly evolving nature of the fund industry and technology, any subject-matter expertise that a director may have developed while fully employed may not remain as current in the months and years following retirement.

Finally, regulatory actions that draw fund boards—even incrementally—toward management functions risk taking directors down a slippery slope. Such steps can lead to a gradual shift in perception as to where to draw the oversight-versus-management line in the future. As a result, boards could be increasingly pushed into management functions and their focus diverted from matters of greatest interest to fund shareholders, such as investment performance. For example, although the proposed requirement that fund boards approve the designation of personnel responsible for liquidity risk management and derivatives risk management programs seems to be a minor new responsibility to impose on fund boards, it represents the kind of incremental shift towards management functions about which we are concerned. Indeed, just as fund board responsibilities have increased incrementally over time, any shift today towards imposing management responsibilities on fund directors could lead, over time, to a set of inappropriate board responsibilities that would be difficult to reverse and that would not be in the best interests of fund shareholders.<sup>14</sup>

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Through the 1940 Act and its amendments, Congress envisioned an oversight role for fund directors. We caution the Commission against imposing management functions on directors that are fundamentally in contravention with that statutory purpose. We recognize that delineating the appropriate oversight role of fund directors is challenging. For this reason, we urge the Commission to hold a roundtable to promote a robust discussion and facilitate a clear understanding among all interested parties on how best to define the fund director's role.

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<sup>14</sup> We agree, as Chair White stated, that it “is incumbent on regulators to avoid completely overloading directors with additional responsibilities, or confusing strong oversight with the management of the fund.” *See* White 2016 Speech, *supra* n. 4.

Mr. Brent J. Fields

June 22, 2016

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If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, at (202) 326-5824.

Sincerely,

A handwritten signature in black ink that reads "Paul K. Freeman". The signature is written in a cursive style with a large, looping initial "P".

Paul K. Freeman  
Chair, Governing Council  
Independent Directors Council

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