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November 7, 2011

Ms. Elizabeth M. Murphy  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549-1090

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

Dear Ms. Murphy:

The Independent Directors Council<sup>1</sup> appreciates the opportunity to provide its views in response to the Commission's request for comments on issues relevant to the use of derivatives by funds.<sup>2</sup> The Release notes that the staff has been exploring the benefits, risks, and costs associated with funds' use of derivatives, including whether current market practices involving derivatives are consistent with the leverage, concentration, and diversification provisions of the Investment Company Act of 1940 ("1940 Act") and "whether funds' boards of directors are providing appropriate oversight of the use of derivatives by the funds."<sup>3</sup> The Release seeks comment on the application of certain provisions of the 1940 Act to derivatives but does not specifically seek comment on director oversight or suggest guidance regarding director oversight.

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<sup>1</sup> IDC serves the 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 the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of \$11.8 trillion and serve over 90 million shareholders, and there are almost 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> *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, SEC Release No. IC-29776 (August 31, 2011) ("Release").

<sup>3</sup> See Release, *supra* n. 2, at 6.

Fund directors have devoted a great deal of attention to derivatives over the past several years, and the role and responsibilities of fund directors in overseeing their use have also received a great deal of attention. Accordingly, IDC believes that regulatory guidance is not needed. As the Commission considers regulations or guidance relating to derivatives, however, IDC urges the Commission to affirm that general oversight is the appropriate role of fund directors and that neither detailed oversight procedures nor special responsibilities are necessary or appropriate. IDC's letter discusses the oversight role of fund directors with respect to derivatives generally and in connection with certain topics or questions raised in the Release.

#### Board Oversight of Funds' Use of Derivatives

A fund board's oversight responsibilities with respect to derivatives are generally the same as for other portfolio investments.<sup>4</sup> Boards oversee portfolio management and the controls and compliance procedures that surround it. Fund boards are not, and are not expected to be, technical experts regarding asset allocation, securities selection, or attribution analysis, and the same should be true of funds' use of derivatives. As investment advisers add new funds or additional investment strategies to existing funds, fund directors acquire a general understanding of the nature, benefits and risks of specific derivative instruments, as well as of the purposes for which they are used in a fund's portfolio and the related overall benefits and risks. In order to achieve this general understanding, boards discuss with the adviser the types of derivatives in which the fund may invest; the expertise, experience and resources of the adviser and relevant service providers with respect to derivatives and their liquidity and valuation; and the policies and procedures designed to identify and control portfolio, operational and valuation risks associated with the derivative instruments proposed to be used by the fund.

The task force of the American Bar Association ("ABA Task Force") that submitted a report to the Division of Investment Management on investment company use of derivatives and leverage similarly described the fund board's role as one "of oversight," stating "that directors should not be required to cross the line to micro-manage a fund's use of derivatives."<sup>5</sup> The ABA Task Force also stated that it believes board oversight of derivatives is "analogous to its oversight of a fund's investments and/or compliance program" and that oversight of derivatives "should not create any new or different responsibilities for a board."<sup>6</sup> Obviously, achieving a general understanding as contemplated above enables boards appropriately to exercise their existing oversight responsibilities.

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<sup>4</sup> See IDC Task Force Report, *Board Oversight of Derivatives* (July 2008) at 2, available at [http://www.idc.org/pdf/ppr\\_08\\_derivatives.pdf](http://www.idc.org/pdf/ppr_08_derivatives.pdf).

<sup>5</sup> See Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010) ("ABA Report") at 46; *see generally*, ABA Report at 43-46.

<sup>6</sup> ABA Report, *supra* n. 5, at n. 30.

### Leverage and Asset Segregation

The Release seeks comment on the current asset segregation approach that addresses the 1940 Act's prohibitions and restrictions on senior securities and leverage. It also seeks input on alternative approaches.<sup>7</sup> As the Release notes, the current asset segregation approach has been developed through Commission and staff guidance, beginning with a 1979 General Statement of Policy that permitted a fund to establish and maintain with its custodian a segregated account containing liquid assets equal to the indebtedness incurred by the fund in connection with the senior security.<sup>8</sup> Through subsequent no-action letters, the staff has provided further guidance to funds concerning the maintenance of segregated accounts or otherwise "covering" their obligations or contingencies in connection with certain senior securities, primarily interest rate futures, stock index futures, and related options. Among other things, the staff guidance indicated the amount to be segregated—*i.e.*, the notional amount or the daily market value—and the type of assets that could be segregated.<sup>9</sup>

The Release discusses some of the criticisms of the current approach, including that it calls for an instrument-by-instrument assessment of the amount of cover required and, thus, creates uncertainty about the treatment of new and innovative derivative instruments. In addition, critics find that, with respect to the amount to be segregated, both notional amount and a mark-to-market amount have their limitations.<sup>10</sup>

The Commission seeks comment on alternative approaches, including one proposed by the ABA Task Force, which recommends that funds have the flexibility to establish their own asset segregation standards for derivative instruments that involve leverage. The ABA Task Force determined that comprehensive guidance covering all types of derivative instruments is unlikely to be achievable, because it is unlikely that any list could cover all present and future types of such instruments. In addition, the appropriate segregation amount likely would be based upon not only the type of derivative, but also other factors, such as the specific transaction and the nature of the assets segregated. The ABA Task Force thus advocates a principles-based approach that permits funds to adopt policies and procedures that would include minimum asset segregation requirements for each type of derivative instrument, taking into account relevant factors. In developing these standards, fund advisers could take into account a variety of risk measures, including Value at Risk (VaR), which nets economically offsetting exposures. These minimum "Risk Adjusted Segregation Amounts" ("RASA")

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<sup>7</sup> See Release, *supra* n. 2, at 18-48.

<sup>8</sup> See *Securities Trading Practices of Registered Investment Companies*, SEC Release No. IC-10666 (April 18, 1979).

<sup>9</sup> See Release, *supra* n. 2, at 23-25 and accompanying notes.

<sup>10</sup> See Release, *supra* n. 2, at 27 and ABA Report, *supra* n. 5, at 16-17.

would be reflected in policies and procedures that would be subject to approval by the fund's board and disclosed in the fund's statement of additional information.

With respect to this approach, the Release asks, among other things, whether boards "as currently constituted, have sufficient expertise to oversee an alternative approach to leverage and derivatives management such as RASA and/or VaR?"<sup>11</sup> It is our understanding that some boards currently oversee portfolio risk monitoring that uses VaR and other sophisticated financial metrics, and extending such an approach to the segregation requirements would be a natural evolution. In any event, fund boards have addressed complex issues in the past and on a regular basis, and there is no reason to believe that they are incapable of addressing this one.

The ABA Task Force's principles-based approach may be the best option because it would, among other things, permit funds to segregate an amount that is tailored to the actual use and purposes of a fund's derivative positions. We agree with the ABA Task Force's suggestion that, if the Commission proposes this approach, it also set forth general guidance. ICI's comment letter also suggests guidance for asset segregation policies, in certain circumstances.<sup>12</sup> For instance, guidance might require periodic stress-testing of asset segregation levels.

The ABA Task Force's approach would require fund directors to approve the asset segregation policies and procedures. The fund's adviser—which has the investment management expertise relating to derivatives—is in the best position to develop the policies and procedures for the board's approval and oversight. Such policies and procedures would be compliance-related, so, under Rule 38a-1 under the 1940 Act, fund directors would be responsible for approving them. The fund's chief compliance officer is responsible for administering the fund's policies and procedures and providing a written report to the board, at least annually, that addresses the operation of the policies and procedures. Fund boards rely on the fund CCO to test the effectiveness of and compliance with the policies and procedures and to report any concerns to the board.

#### Securities-Related Issuers, Diversification, and Concentration

The Release seeks comment on the application to derivatives of the 1940 Act's prohibition on investments in securities-related issuers and provisions concerning portfolio diversification and concentration. The provisions raise a number of questions regarding how they should apply to derivatives. For example, the identification of the "issuer" for purposes of applying securities-related issuers, diversification, and concentration tests is important to the design of portfolio and regulatory

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<sup>11</sup> Release, *supra* n. 2, at 43.

<sup>12</sup> See Letter from Karrie McMillan, General Counsel, ICI, to Elizabeth M. Murphy, Secretary, SEC, regarding Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (File Number S7-33-11) (November 7, 2011) ("ICI Letter").

compliance programs, and a derivative investment can create exposures to both the underlying reference asset and the credit of the counterparty to the derivatives contract. In its comment letter, ICI recommends that funds be required to look through derivatives and apply the diversification, concentration, and securities-related issuers tests to reference assets and that a new rule be promulgated to more specifically and appropriately address counterparty risk.<sup>13</sup>

Regardless of how the Commission ultimately determines to address the application of these provisions to derivatives, IDC urges the Commission to make clear that fund boards may make reasonable business judgments based on information and analyses prepared by advisers and subject to monitoring under compliance policies and procedures adopted under Rule 38a-1 under the 1940 Act. This is, of course, similar to fund directors' current oversight of funds' compliance with the existing provisions governing investments in securities-related issuers and portfolio diversification and concentration as part of their responsibilities under Rule 38a-1.

### Valuation

The Release seeks comment on funds' valuation of derivatives. Although fund boards are ultimately responsible for the fair valuation process, they typically adopt valuation policies and procedures that generally delegate day-to-day responsibility to price the fund's investments, including those that must be priced at "fair value," to the adviser or other service provider (such as the accounting agent).<sup>14</sup> Funds boards fulfill this responsibility with diligence and care. In light of the variety and complexity of derivative instruments and the valuation methodologies that are applied to them, as well as the absence of any significant problems in this area, IDC does not believe there is a need for the Commission to issue guidance on the fair valuation of derivatives at this time.

### ETF Moratorium

The Release notes the Commission's announcement in March 2010 of the staff's moratorium on the issuance of exemptive relief relating to exchange-traded funds pending completion of its review of the use of derivatives by funds.<sup>15</sup> Although the 1940 Act and its rules can be improved through modernization, as discussed in the Release, they nevertheless have provided, and continue to provide, sufficient investor protection in their current form. Accordingly, in light of the competitive disadvantage this position imposes on those who were not able to gain exemptive relief prior to the moratorium, IDC urges the Commission to lift the moratorium as soon as practicable, consistent with the protection of fund investors.

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<sup>13</sup> See ICI Letter, *supra* n. 12.

<sup>14</sup> See IDC Task Force Report, *supra* n. 4, at 16.

<sup>15</sup> See Release, *supra* n. 2, at n. 8.

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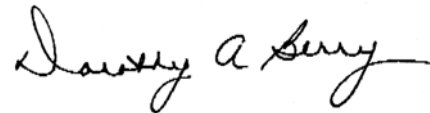
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If you have questions or would like additional information, please contact Amy Lancellotta, Managing Director, Independent Directors Council, at 202/326-5824.

Sincerely,

A handwritten signature in black ink that reads "Dorothy A. Berry". The signature is written in a cursive, flowing style.

Dorothy A. Berry  
Chair, IDC Governing Council

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