



# MUTUAL FUND DIRECTORS FORUM

*The FORUM for FUND INDEPENDENT DIRECTORS*

April 20, 2015

Mr. Brent J. Fields  
Secretary  
United States Securities and Exchange Commission  
100 F Street N.E.  
Washington, DC 20549

Re: Proposed Rulemaking Regarding Disclosure of Hedging by Employees, Officers and Directors, File No. S7-01-15

Dear Mr. Fields:

The Mutual Fund Directors Forum (“the Forum”)<sup>1</sup> welcomes the opportunity to comment on the recent proposal by the Securities and Exchange Commission (“Commission”) to require disclosure in the annual meeting proxy statement of whether certain individuals are permitted to engage in hedging transactions of company equity securities.<sup>2</sup>

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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The Commission’s proposal is directed primarily at requiring operating companies to disclose whether they and their boards have adopted policies prohibiting or limiting the ability of their directors (and employees) to hedge positions they hold in the company. This rule proposal, mandated by the Dodd-Frank Act, is motivated by a desire to provide more comprehensive

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<sup>1</sup> 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.

<sup>2</sup> Proposed Rulemaking: Disclosure of Hedging by Employees, Officers and Directors, Release No. 33-9723 (Feb. 17, 2015) [80 FR 8485 (Feb. 17, 2015)] (“Release”).

disclosure to investors on whether the interests of the directors they elect are fully aligned with their own interests, and in particular whether directors share their interest in the long-term economic success of the company.

While the Commission also specifically suggests that the requirement should not be imposed on open-end investment companies, it would apply to closed-end funds.<sup>3</sup> For the reasons outlined below, we agree with the Commission that the proposed disclosure should not apply to open-end funds. Further, because positions in closed-end funds are very difficult to hedge effectively, we urge the Commission to reconsider imposing the requirement on these funds, as we believe it is unnecessary and potentially burdensome.

### **The Disclosure Should Not Apply to Open-End Funds**

Directors play a critical role in protecting investors in open-end mutual funds. Among other things, they protect shareholders from conflicts of interest that are inherent in the asset management business, approve the advisory fee paid by fund investors, oversee the activities of others that provide services to the fund and, when appropriate, encourage the fund's adviser to take necessary actions to improve the fund's investment performance.

Not surprisingly, fund shareholders have an interest in whether their directors' interests are aligned with their own. But, as the above shows, fund investors' interest is less in whether directors are exposed to the specific fund in which they have invested, and more to whether directors are incentivized to oversee the full range of the adviser's activities. The Commission's rules, which require disclosure of each director's investments in the complex of funds as a whole, have long recognized this fact. Likewise, many fund boards also have recognized this by requiring their members to maintain a set level of investment not in specific funds, but in the complex as a whole. Fund shareholders are thus less likely than the shareholders of operating companies to be interested in whether directors have somehow protected themselves against the risk of poor performance in the fund in which they have invested.

In addition, even if a director wanted to hedge his or her position in an open-end fund, it would be extremely difficult to do so. The types of securities that the Commission identifies as potential ways for a director to hedge his or her position in an operating company – whether through short sales, through use of options, or through more exotic instruments – typically do not exist with respect to open-end mutual funds. Hence, as the Commission appears implicitly to recognize, there is simply not a problem in this area that needs to be addressed.

Finally, as the Commission recognizes, open-end funds differ from operating companies in a number of ways. In particular, the Commission notes that:

- Open-end fund shares are bought from and sold to the fund at net asset value;

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<sup>3</sup> As proposed by the Commission, this exclusion would extend to exchange-traded funds (“ETFs”) irrespective of whether they are registered as open-end funds or unit investment trusts (“UITs”). Notably, as the Commission recognizes, ETFs registered as UITs do not have directors.

- Fund personnel are compensated by the fund’s adviser rather than the fund itself;
- Directors typically do not directly receive fund shares as part of their compensation;
- Open-end funds are not typically required to hold annual meetings or solicit proxies on an annual basis; and
- There are generally no efficient means to hedge a position in fund shares.

We agree that these reasons provide an additional basis for distinguishing open-end funds from listed operating companies.

As a result, there is simply no reason to require that open-end funds adopt policies with regard to hedging, police those policies on an ongoing basis, and provide unneeded, unhelpful and potentially confusing disclosure to fund shareholders about these policies.<sup>4</sup> We thus strongly agree with the Commission’s view that open-end funds should not be included within the scope of the rule.

### **Closed-End Funds Share Many Characteristics with Open-End Funds, Justifying Their Exclusion from the Disclosure**

In contrast to open-end funds, the Commission suggests that certain closed-end funds should fall within the scope of the rule. We believe, however, that closed-end funds share many similar characteristics with open-end funds, justifying the exclusion of closed-end funds from the rule. In particular, we believe that, in contrast to operating company shares, it is typically very difficult to hedge closed-end fund shares, either by selling them short or by trading in options on or other similar derivatives of the closed-end fund’s shares. Hence, in our opinion, requiring the disclosure for closed-end funds would impose a regulatory structure over a problem that is unlikely ever to exist.<sup>5</sup>

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<sup>4</sup> This stands in contrast to transactions a director might make in securities in the fund’s portfolio. To the extent that those transactions are impermissible, they are addressed by existing rules, including the prohibition on insider trading in Exchange Act rule 10b-5 and the requirement in Investment Company Act rule 17j-1 that funds have codes of ethics.

<sup>5</sup> Moreover, the Commission’s proposal lacks clarity with respect to what would constitute a hedge of a position in a closed-end fund. Direct hedges for closed-end funds are not widely available, leaving only imprecise hedges (such as shorting an index fund correlated with the closed-end fund or shorting securities likely to be held in the fund’s portfolio) available for directors. By itself, as with open-end funds, this provides a basis for not imposing the rule on closed-end funds. In addition, because these hedges are inexact, it will be very difficult if not impossible to differentiate between what constitutes a hedge and what constitutes ordinary portfolio transactions by the director. Thus, should the Commission continue to believe that this rule should be imposed on closed-end fund directors, it should, in order to provide certainty, clarify that the rule applies only to the use of hedge instruments tied directly to the price of the closed-end fund shares, and not to positions that might appear to be but are not necessarily related to a director’s position in the shares of the closed-end fund.

We would be pleased to discuss any of these issues with you in greater detail. Please feel free to contact me at [REDACTED] or Susan Wyderko, the Forum's President, at [REDACTED] at any time.

Sincerely,

A handwritten signature in black ink, appearing to read "David B. Smith, Jr.", with a stylized flourish at the end.

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