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[redacted]

March 29, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (Investment Company Act Release No. 31933)

File No. S-7-24-15

Dear Mr. Fields:

This letter responds to the request of the Securities and Exchange Commission (the "Commission") for comment in Release No. IC-31933 (Dec. 11, 2015) (the "Proposing Release"), in which the Commission proposes to adopt a new Rule 18f-4 ("Proposed Rule 18f-4" or the "Proposed Rule") under the Investment Company Act of 1940, as amended ("1940 Act"), and to adopt certain amendments to proposed Form N-PORT and proposed Form N-CEN (altogether, the "Proposal").[1] I appreciate having the opportunity to respond to the Proposal.[2]

As stated in the Proposing Release, the Proposal is intended to enhance investor protection, to address concerns identified by the Commission under Section 18 of the 1940 Act, and to provide an updated, comprehensive approach to the regulation of the use of derivatives by registered investment companies, through the adoption of Proposed Rule 18f-4. The Proposing Release contains a comprehensive statement

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[1] *See* Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,883 (proposed Dec. 11, 2015).

[2] The undersigned is an independent trustee of ARK ETF Trust and is an attorney whose primary area of practice over the last 40 years has focused on investment companies and their boards of directors/trustees, investment advisers, and mutual fund distributors and transfer agents. I was employed by OppenheimerFunds, Inc. for more than 31 years, and served as an Executive Vice President and General Counsel of that company, which is the investment adviser to the Oppenheimer mutual funds. I have also been affiliated with several law firms throughout my career, most recently until April 2014. Currently, I am an Adjunct Professor at the University of Virginia School of Law, where I teach a course on Federal Regulation of Investment Companies and Investment Advisers. I also serve on the investment committees and audit committees of several charitable endowments, and am an associate member of the Committee on Investment Management Regulation of the New York City Bar Association. This letter represents my own views, and not the views of any investment company board, company, educational institution, law firm or other entity with which I am, or have been, affiliated in any of the capacities noted herein.

of the Commission's views about the implementation and management of derivatives transactions and "financial commitment transactions" by investment companies. The substantive and thoughtful manner in which the Commission has analyzed and discussed the use of derivatives by investment companies in the Proposing Release by itself will be of great assistance to investment advisers and the boards of directors and trustees of investment companies in determining their approach to the use and management of derivatives in investment company portfolios, and the Commission (and its Staff) should be commended for this effort. In that light, this letter is offered in the spirit of what is intended to be a constructive commentary on certain aspects of the Proposed Rule, primarily as to the effect I believe it would have on investment company boards, if it is adopted as proposed.

The Proposed Rule would apply not only to registered open-end funds ("Mutual Funds"), but also to exchange-traded funds ("ETFs"), closed-end funds, and business development companies ("BDCs") (collectively, "Funds"). The Proposed Rule would update and, in certain cases, replace existing Commission guidance on the use of derivatives by Funds[3] and would rescind certain "no-action" letters issued by the Staff of the Commission with respect to the use of "derivatives transactions" and "financial commitment transactions" (as each term would be defined in the Proposed Rule). Under the Proposal, a Fund that intends to rely on Proposed Rule 18f-4 to enter into derivatives transactions would be required to (1) comply with one of three alternative portfolio limitations ("Portfolio Limitations"), imposing a limit on the amount of leverage the Fund could obtain through use of derivatives transactions and other "senior securities" transactions; (2) maintain an amount of "qualifying coverage assets" to manage risks arising from the use of derivatives; and (3), if a Fund uses derivatives to a substantial degree, adopt and implement a formal derivatives risk management program ("Program").

While the Proposal states that the risk of use of undue leverage by investment companies was a basic concern leading to the adoption of the 1940 Act, that the use of derivatives may inadvertently mask risks equivalent to leverage and that risk management tools have been developed that may be useful for the measurement and management of such risks, certain aspects of the direction the Commission proposes to take in response, through the adoption of Proposed Rule 18f-4, raise concerns. I support what I believe to be the overall goal of the Proposal to strengthen investor protection by providing an updated, comprehensive approach to the use of derivatives by Funds, in light of the "dramatic growth in volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds,"[4] but I also respectfully offer suggestions for a somewhat different approach to achieving those important goals. Based upon my studies of the Fund industry and my practical experience in working with Fund portfolio and risk managers as well as Fund boards of directors/trustees, I recognize

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[3] *See* Proposing Release, p. 260, stating that if the Proposed Rule is adopted, the Commission would withdraw Release 10666 [Securities Trading Practices of Registered Investment Companies, Rel. No. IC-10666 (Apr. 18, 1979)] ("Release 10666") and would rescind certain "no-action" guidance provided by the Staff of the Commission addressing derivatives and financial commitment transactions. I note that while Proposed Rule 18f-4, if adopted, would provide a formal regulatory framework for the use of derivatives by Funds, Release 10666 contained substantial and substantive guidance by the Commission with respect to its views on Funds' derivatives practices. While the Proposing Release updates the Commission's views with respect to Funds' use of derivatives in a manner that "fleshes out" the underpinnings of the Proposed Rule, the Proposing Release will not have the effect of providing ongoing formal Commission guidance to Funds with respect to these practices as is currently provided in Release 10666.

[4] Proposing Release, p. 9.

that risk management is a core component of sound portfolio management and portfolio construction processes and that it is highly appropriate for the Commission to articulate the outline of what it believes to be the framework for sound risk management in connection with the use of derivatives by Funds.

In this letter, I respectfully offer comments and suggestions on several aspects of the Proposal and respond to certain of the Commission's associated requests for comment. A summary of my overall comments follows:

1. **The Proposed Rule would assign operational and portfolio management responsibilities to Fund Boards that do not align with functions and duties of Boards of Directors under state laws and would overburden Directors**. I believe that the Commission should re-evaluate the nature of the responsibilities that Proposed Rule 18f-4 would place on the boards of directors or trustees of Funds ("Boards" or "Directors"), because as set forth in the Proposal, those responsibilities go far beyond what are traditional Board "oversight" responsibilities, and would inject Boards into what are essentially portfolio design, management and implementation decisions for which many Board members may not have the necessary skills and background. Additionally, the amount of time that Boards would be required to devote to such "oversight" under the Proposed Rule would substantially and negatively affect Boards' abilities to carry out their other existing statutory and regulatory duties. Instead, I believe that the final version of Rule 18f-4 should assign the responsibilities for designing and implementing a Fund's derivatives program to the Fund's investment adviser, with periodic reporting to the Board about the adviser's implementation of that program.
2. **The Proposal should clarify the respective responsibilities and interrelationships of the CCO and other risk officers.** Under Proposed Rule 18f-4(a)(3)(ii)(C), in the case of a Fund that is required to adopt and implement a Program, the Fund will be required to "designate an employee or officer of the fund or the fund's investment adviser (who may not be a portfolio manager of the fund) responsible for administering the policies and procedures incorporating the elements [set forth in the Proposed Rule concerning the implementation of a Program], whose designation must be approved by the fund's Board, including a majority of the Directors who are not interested persons of the fund" (that person is referred to herein as the "Risk Officer"). In addition to my comment below that it is inappropriate for a Fund's Board to be required to select management personnel of the investment adviser (which is essentially what the Risk Officer would be), I believe that the Proposed Rule (and the explanation of the Commission's views with respect thereto in the Proposing Release) does not set forth adequately the operational interaction of the roles, responsibilities and authority of a Fund's CCO, Risk Officer and liquidity risk manager (to be appointed by Funds pursuant to the Commission's proposed Rule 22e-4[5]) from a regulatory and practical perspective. I suggest that the adopting release for, and, indeed, the final version of Rule 18f-4, should clarify the interrelationships of a Fund's Chief Compliance Officer, its derivatives risk management officer (if the final rule includes the requirement to select one)

5 *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release 31835 (Oct. 15, 2015) (the "Liquidity Risk Management Proposal").

and the Fund's liquidity risk management officer(s) designated under the Commission's Liquidity Risk Management Proposal.[6]

3. **The Commission should evaluate whether the Proposed Rule will create potential barriers to entry in the fund industry.** The Commission should further evaluate the potential costs of its Proposal with respect to the creation of possible "barriers to entry" for smaller or newer entrants into the Fund industry arising from the necessity under Proposed Rule 18f-4 to adopt a formal derivatives risk management Program and hire or designate a Risk Officer. In that light, the final version of the rule should allow funds to use a third-party administrator for derivatives risk management.

4. **Greater clarity is needed as to the definitions of certain terms used in the Proposed Rule and Form N-PORT.** The Commission should provide greater clarity as to the meaning of certain terms used in the Proposed Rule and amendments to proposed Form N-PORT. Proposed Rule 18f-4 would impose compliance requirements on Funds on the basis of language and terms that are undefined in the Proposed Rule and that have no reference in other federal securities laws or, I believe, in the common "investment vocabulary" of investment advisers to investment companies, or of Fund Boards. In particular, I am concerned about the lack of definitional clarity provided in the Proposed Rule for terms such as "VaR," "stressed market conditions," and "confidence level," and in proposed amendments to Form N-PORT for terms such as "gamma" and "vega." Allowing Funds and their investment advisers to apply potentially widely varying interpretations to those terms in compliance programs could result in lack of uniformity in the application of those terms and disparate approaches to implementation of the management of derivatives, all of which could undercut the Commission's goals.

5. **The Proposal provides no guidance as to the effect of a Fund's use of derivatives on its compliance with 1940 Act requirements as to "diversification" and "concentration."** By not addressing these critical issues, the Commission has left open the possibility that different Funds and investment advisers will continue to interpret those 1940 Act requirements differently with respect to derivatives transactions.

6. **The Commission's goals could better be accomplished by (a) narrowing the Proposed Rule to eliminate specific portfolio management requirements and the assignment of portfolio managerial oversight functions to Fund Directors and (b) issuing updated guidance on the Commission's Views on the use of derivatives and financial commitment transactions.** Rather than enacting a rule that would essentially prescribe specific investment and portfolio management policies and procedures with respect to the use of derivatives by Funds, which I believe would represent an exercise of portfolio and risk management judgment by the Commission that is better left to professional investment advisers, the Commission could better accomplish its underlying goals by narrowing the scope of the Proposed Rule and by providing its views on these matters to the Fund industry through the use of guidance in an Interpretive Release, as it has done in the past, for example by the issuance of Release 10666.

These areas of comment are more fully discussed below.

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6 *See* Liquidity Risk Management Proposal, discussion of general elements, p. 46.

1. The Proposed Rule would assign portfolio managerial and operational responsibilities to Fund Directors that are not specified under the 1940 Act and that do not align with the functions assigned to Boards of Directors under state laws, and would overburden Directors.

My concerns principally relate to the substantial responsibilities entailing decisions on highly technical matters that would be assigned to Fund Boards under the Proposal. I respectfully offer an alternative approach that I believe would address the Commission's purpose in heightening the attention placed by Funds, their investment advisers and Boards on Funds' use of derivatives. In brief, if the Commission chooses to adopt a prescriptive rule rather than to narrow the focus of the Proposed Rule and issue formal interpretive guidance on Funds' use of derivatives, I believe that the Commission's goals outlined in the Proposal can be accomplished by allowing Boards to delegate the primary responsibility for designing, developing and implementing a Fund's procedures and policies for compliance with the Proposed Rule to the Fund's investment adviser, because the design, development and implementation of any process for the use of portfolio investments, such as derivatives, and in particular the development of a derivatives risk management Program essentially represent the exercise of portfolio management judgment, which is a function with which a Fund Board should not be tasked.

a. The Proposal would assign responsibilities to Fund Boards that are, essentially and functionally, operational and highly complex portfolio management decisions.

Under the Proposed Rule, the Board of a Fund relying on Proposed Rule 18f-4 to engage in derivatives transactions would be required to undertake substantial additional responsibilities with respect to a Fund's portfolio management activities:

(1) The Board would be required to approve which of the two alternative Portfolio Limitations would apply to the Fund under Proposed Rule 18f-4(a)(1);

(2) The Board would be required to approve policies and procedures reasonably designed to provide for a Fund's maintenance of "qualifying coverage assets" under Proposed Rule 18f-4(2);

(3) To enable a Fund to limit its derivatives transactions under Proposed Rule 18f-4(a)(4) so that the Fund would not be required to adopt a Program, the Fund's Board would be required to approve an alternative Portfolio Limitation pursuant to which the Fund's aggregate exposure associated with derivatives transactions, after entering into any derivatives transaction, does not exceed 50% of the value of the Fund's net assets; and

(4) If the Fund were required by the Proposed Rule to adopt a Program, the Board would be required (a) to consider the approval of a Fund's initial Program and any material changes to it; (b) to review a written report (at least quarterly) by the person responsible for administering the Program (the Risk Officer) that describes the adequacy of the Program and the effectiveness of its implementation; and (c) as described above, to approve the designation of the person selected as the Risk Officer.

The Proposing Release states (as did the Liquidity Risk Management Proposing Release, using nearly identical language) that "[g]iven the board's historical oversight role, we believe it is appropriate to require a fund's board to approve the fund's derivative risk management program." [7] There is no doubt an important role for a Fund's Board in overseeing a Fund's use of derivatives and financial commitment transactions, but that role could be fulfilled by having the Board receive periodic informational reports from the Fund's investment adviser on such matters in the same manner that the Board reviews other portfolio management and risk management-related decisions and actions taken by the investment adviser to implement the Fund's investment policies and investment program designed to seek the Fund's investment objective. There is a substantial difference between "approving" policies, which entails active decision-making that must be based upon knowledge and expertise as to the subject matter and operation of such policies, and "receiving" reports, which entails oversight of the decision-making by others employing their knowledge and expertise to implement such policies.

That difference is not insignificant. The Proposed Rule would require much more than mere Board "oversight" of an investment adviser's use of derivatives in a Fund's portfolio. The responsibilities described above would, in effect, require Fund Directors to exercise what is, in essence, a functional managerial role with respect to what are essentially portfolio management decisions about Fund business and operational matters. The exercise of those proposed responsibilities would not be mere "oversight" of the actions of the Fund's investment adviser, because they would require Boards to make specific decisions with respect to the use of particular portfolio investments, thus requiring that Boards be or become highly knowledgeable about the technical, economic and operational characteristics of derivatives transactions, in order for Boards to carry out those assigned responsibilities in a competent manner. Carrying out those responsibilities would entail judgments and decisions that would likely exceed the professional capacity and investment expertise of many Fund Directors.

The Proposed Rule would require the Board of a Fund using derivatives that (a) would have an exposure to derivatives exceeding 50% of its net asset value or (b) uses any "complex derivative" to approve the adoption of a derivatives risk management Program. Among other factors that the Commission states a Board should consider in deciding whether to approve a Program or any material changes to it are:

- The types of derivatives transactions in which a fund engages or plans to engage and their particular risks,

- Whether the Program sufficiently addresses the Fund's compliance with its investment guidelines, any applicable portfolio limitation and relevant disclosure,

- The adequacy of the Program from time to time in light of past experience (both by the Fund and with market derivatives use in general) and recent experiences,

- Best practices used by other fund complexes,

- Consultations with experts familiar with derivatives risk management by similar funds or market participants.

Again, consideration of those factors would require a high degree of substantive knowledge and professional expertise on the part of a Fund Board with respect to the use, operation and economic effect

7 Proposing Release, 226.

of derivatives transactions. Moreover, the components constituting "required Program elements" described in the Proposed Rule (including, for example, any models, such as VaR calculation models used by the Fund) would have to be evaluated by the Fund's Board in determining whether to adopt the Program and any material changes to it.[8] I believe that those types of assessments are so technical and complex in nature that they should be carried out by the Fund's investment adviser, not by a Board approval process.

In one of the questions for which the Commission seeks public comment, it asks whether instead of asking Boards to "review" the written report provided periodically by the Risk Officer describing the adequacy of the Fund's Program and the effectiveness of its implementation, the Proposed Rule should, like Rule 38a-1, require reports to be "submitted" to the Board.[9] I believe that in either case, a Board seeking to discharge its fiduciary responsibilities would feel compelled to review, analyze, understand, and, if necessary, take appropriate action with respect to such a report "submitted" to it, so as not to be viewed as a "rubber stamp." Reviewing a report on derivatives use that goes into the highly technical operational aspects of derivatives (such as the calculation of a Fund's VaR) and that would entail analysis and comparisons of a Fund's practices with the derivatives practices of other market participants (perhaps through the use of consultants) would require Boards to become involved in highly technical portfolio management analysis. Also, the additional costs of retaining independent consultants to survey and report on such industry practices may be a substantial burden for smaller funds and fund complexes.

An analogy to that requirement would be requiring the board of directors of an automobile company not merely to receive a report from management of the company that management has adopted and implemented product safety practices and procedures but to review the actual test results of those procedures, for example, in the manufacture, assembly and maintenance of the bushings for front axle components, and every other component of the automobile in the manufacturer's production process, to determine if they were adequate, and to compare them to the practices of other automobile companies. That is simply not the role prescribed by state law for a board of directors, nor is it the type of role that the 1940 Act prescribes for Fund Directors.

The Commission's approach under the Proposal, by adding yet more Fund business management responsibilities to the agenda of Fund Boards, is a departure from both the statutory role assigned to Fund Boards by Congress in adopting the 1940 Act and the Commission's own previous concerns about overburdening Fund Boards in matters that do not involve conflicts of interest. Initially, the 1940 Act assigned only three specific responsibilities to Fund Boards: (1) adoption and annual renewal of the investment advisory agreement, (2) adoption and annual renewal of the principal underwriting agreement, and (3) annual selection of a Fund's principal accounting officer[10] and subsequently two additional responsibilities were added in the final version of the 1940 Act as adopted: selection of the Fund's independent public accountants, and valuation of securities not having readily-available market

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8 Proposed Rule 18f-4(a)(3).

9 Proposing Release, p. 228.

10 Sections 15(b)(2), 15(c)(1) and 32(b) of S. 3580, 76th Cong., 3d Sess., March 13, 1940. *See* SEC Chair Mary Jo White, "The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference," Washington, D.C., March 29, 2016 ("White Speech").

quotations.[11] In helping the Commission to carry out its responsibilities to implement the 1940 Act, the Staff of the Commission has expressed its own concern about involving independent Directors of Funds in matters that do not entail management of conflicts of interest:

> [W]e believe that independent directors perform best when required to exercise their judgment in conflict of interest situations—for example, when they review advisory contracts under sections 15(c) and 36(b) or review the use of affiliated brokers under rule 17e-1. We believe that independent directors are unnecessarily burdened, however, when required to make determinations that call for a level of involvement in day-to-day activities. Rules that impose specific duties and responsibilities on the independent directors should not require them to "micro-manage" operational matters. To the extent possible, operational matters that do not present a conflict between the interests of advisers and the investment companies they advise should be handled primarily or exclusively by the investment adviser.[12]

In the view of Alfred Jaretzki, Jr., one of the individuals most notably responsible for the architecture and language of the 1940 Act, just as the role of a director under state law is limited, the role of Fund Directors was intended by the drafters of the 1940 Act to be limited, and was considerably more circumscribed than the role of Directors embodied in the sweeping new responsibilities for Fund business management decision-making contemplated by the Proposed Rule. Mr. Jaretzki discusses the scope of a director's responsibilities under state law in that context:

> Frequently [directors] will be called upon to examine reports circulated between meetings and occasionally to engage in other activities not requiring group action as a board. If the directors know any facts which would awaken suspicion and put a reasonable man on his guard, something more will be required. But it is clear that the director, in assuming office, does not undertake to devote any really substantial amount of his time to the business of the company, and that he exercises his function primarily at periodic meetings of the board. *He is not expected to interfere individually in the actual conduct or operation of the corporation's affairs.*
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> Neither does the law require that the directors have any special or technical talent or expertise in the business of the company. They do not hold themselves out as having better judgment than that of a reasonably prudent man of affairs or as assuring that the results of their management will be successful or even satisfactory (emphasis added).[13]

In addressing the role of Directors of Funds with respect to portfolio matters, Mr. Jaretzki noted:

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11 For an excellent discussion of the evolving Commission interpretation of the role of independent Directors of Funds, *See* Matthew P. Fink and Jacqueline Edwards, "The Changing Role of Independent Directors of Mutual Funds," 23 *The Investment Lawyer* No. 4, Apr. 2016.

12 Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (Washington, D.C.: Government Printing Office, May 1992), 266.

13 Alfred Jaretzki, Jr., "Duties and Responsibilities of Directors of Mutual Funds," *Law and Contemporary Problems*, Summer 1964 777, 779 ("Jaretzki").

> It is not the duty of the board itself specifically to select each individual security for purchase or sale. It is sufficient if the directors are satisfied that purchases and sales are competently handled either by the officers of the [fund] or by the investment adviser under whatever general directions they may wish to impose and pursuant to the objectives of the fund and the limitations to which it is subject . . . . [I]t is sufficient if the directors are kept currently advised of purchases and sales made by the appropriate officers of the fund, or the investment adviser, as the case may be, and are periodically informed of the reasons for the investment decisions.[14]

Clearly, over time, the role of Directors has become more complex and particularized than the original drafters of the 1940 Act contemplated. Perhaps that was inevitable, given the increasingly complex nature of fund investment and operational activities. However, that increasing complexity does not necessarily mean that the direct responsibility for the day-to-day management of those operational and investment functions should be shifted to Fund Directors, rather than allowing Directors to use their reasonable business judgment to retain expert and professional investment advisers to perform those functions under the general oversight of the Board.

b. The Adopting Release for the final version of the Proposed Rule should clearly state the standard of care the Commission expects to be applied to a Fund's Board in carrying out its responsibilities under the final rule.

The Proposal states[15] that a Board could exercise the role prescribed for it with respect to the adoption and implementation of a Fund's Program by relying on "summaries" of highly complex derivatives risk management structures provided by a Fund's Risk Officer, legal counsel or "other persons" familiar with the Program. However, I believe that Boards may be reluctant to rely on summaries, given the sophisticated level of the evaluation of technical matters that would be required under the Proposed Rule and the fact that a Board's conduct in evaluating the adoption and implementation of a Program as contemplated by the Proposed Rule would be measured in light of the fiduciary standard to which Boards are subject under applicable state laws in exercising their duties.

The Proposed Rule sets forth the aforementioned responsibilities for Boards of Funds with respect to oversight of a Fund's adoption and implementation of a Program. As in the case of the 2011 Comment Letter on Money Market Fund Reforms of the N.Y. City Bar Association (which I helped draft)[16], and as in that Committee's 2014 Comment Letter on the removal of NSRO ratings requirements from Rule 2a-

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14 Jaretzki at 784.

15 Proposing Release, pp. 226-227.

16 *See* Comment Letter of the Committee on Investment Management Regulation of the New York City Bar (Apr. 29, 2011), *available at* http://www.sec.gov/comments/s7-07-11/s70711.shtml.

7[17] and in its Liquidity Risk Management Proposal Comment Letter[18] (both of which I also helped draft), I am again concerned about the heightened possible exposure of Fund Boards to litigation risk and risk of enforcement actions by the Staff of the Commission posed by the additional assignment of responsibilities to Boards under the Proposed Rule with respect to determinations with respect to a Fund's use of particular derivatives. I therefore urge that the adopting release for the final version of the Proposed Rule should include a statement by the Commission recognizing that the Commission will assess a Board's exercise of whatever responsibilities are assigned to the Board under the final rule in light of the Board's good faith application of its reasonable business judgment.[19] I believe that such acknowledgment by the Commission will assist Boards in retaining the benefit of the business judgment rule, rather than becoming subject to potential litigation challenges for taking on management responsibilities that require levels of expertise beyond what reasonably can be expected of individual Directors.

I respectfully submit that the complexities of the considerations the Proposed Rule would impose on Boards go beyond the oversight role of Boards as "watchdogs" on behalf of shareholders[20] as it has evolved under applicable state and federal laws. In whatever form the Commission may determine to issue a final rule, I believe it would be helpful if the adopting release for the final version of such rule contained a clear statement about the standard of care – which I believe should be a "reasonable business judgment" standard – to which the Commission would hold such Boards in their exercise of their functions under the final rule.

c. The Proposed Rule would add significant burdens to the already-substantial responsibilities assigned to boards under the 1940 Act and rules adopted by the Commission thereunder.

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17 *See* Comment Letter of the Committee on Investment Management Regulation of the New York City Bar (Oct. 14, 2014), *available at* http://www.sec.gov/comments/s7-07-11/s70711.shtml.

18 *See* Comment Letter of the Committee on Investment Management Regulation of the New York City Bar Association (Jan. 13, 2016) (the "NYC Bar Liquidity Risk Management Proposal Comment Letter"), with respect to the Commission's Liquidity Risk Management Proposal.

19 In adopting Rule 2a-7 in 1983, the Commission commented on the nature and extent of a Board's fulfillment of the responsibilities set forth in that rule. In response to concerns raised by some commenters that a Fund's failure to maintain a stable net asset value should not give rise to a presumption that the Fund's Board had failed to fulfill its responsibilities, the Commission stated:

> [T]he Commission does not expect the board of directors to be insurers of the activities of the investment adviser or the fund. <u>*The Commission has evaluated in the past, and would similarly evaluate in the future, the actions of the board of directors based upon a reasonable business standard*</u> . . . . The mere adoption of those specific procedures required by the rule and exemptive orders will not, *per se*, fulfill the board's responsibilities. On the other hand, if a board adopts procedures which are reasonably designed to assure stability and the board acts in a reasonable fashion to assure that those procedures are followed, the Commission would not hold the board responsible for any failure to maintain a stable net asset value per share.

20 *See Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)).

The Proposal's assignment of additional responsibilities to Fund Boards will require Boards to spend a significant amount of additional time on derivatives management issues, impinging on the time available to Boards to deal with other important matters, such as the review of investment advisory agreements, general underwriting arrangements, affiliated transactions, proxy voting, cybersecurity risks, and Rule 12b-1 plans, to name but a few. Having yet an additional time-consuming responsibility added to its already-substantial list of statutory duties will possibly have the effect of causing Boards to have less time to devote to those other important responsibilities that are directly required by the 1940 Act or Commission Rules, especially those that are derived from the Board's principal statutory role in monitoring, mitigating and, where necessary, eliminating conflicts of interest between a fund and its affiliates.

Underscoring that concern, attached as Exhibit A is a list of those responsibilities for which Boards currently must devote substantial time and resources, not the least important of which is the annual review and renewal of a fund's investment advisory agreement and underwriting agreement. The additional tasks that the Proposed Rule would assign to Directors would add significantly to that burden, without providing any clear benefit to Funds and their shareholders from having Directors engage in decision-making with respect to adoption and implementation of portfolio management policies and procedures of a highly technical nature.

The Commission has expressed its own concerns about overburdening Directors when crafting new rules that will impose additional responsibilities on Fund Boards. As noted by Commission Chair Mary Jo White in a very recent address on the role of Fund Directors:

> Lest my remarks leave you rethinking whether you really want to be a fund director, let me move to a discussion of what is not expected of you. While I cannot overstate the importance of directors, especially independent fund directors, fully fulfilling their responsibilities to investors, it also is incumbent on regulators to avoid completely overloading directors with additional responsibilities, or confusing strong oversight with the management of a fund. It is obviously the fund's adviser that is typically tasked with day-to-day management of a fund, and it is a fund's chief compliance officer who is tasked with administering the fund's compliance policies and procedures as approved by the board. The role of the board is to provide independent oversight of these and other critical functions, and to approve compliance policies and procedures, not to perform them.
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> We need to continue to be sensitive to where a director's oversight responsibility could cross the line into day-to-day management. Determining an appropriate dividing line is a challenge, one that the SEC is grappling with as we consider proposed reforms designed to address the increasingly complex portfolios and operations of mutual funds and ETFs.[21]

Chair White's remarks sound the right tone, in my view, in recognizing the need by the Commission to distinguish oversight from day-to-day management when crafting rules affecting the role of Fund Directors. For the reasons set forth in this letter, I respectfully suggest that the Proposed Rule does not

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21 White Speech, at p. 4.

fulfill that goal, and the assignment of management responsibilities to Directors under the Proposed Rule crosses the line the Chair identifies.

Another potential detrimental effect of imposing highly technical portfolio management and operational decision-making responsibilities on independent directors would be the strong possibility that fewer individuals would be willing to serve on boards because of the increasingly demanding level of technical expertise and specialization that requirements imposed under the Proposed Rule would entail. That was a risk envisioned by the drafters of the 1940 Act:

> If the extent of these duties and responsibilities [of Fund Directors] were pressed to a point where they could be fulfilled only by an expert and require an inordinate amount of time, the choice of non-affiliated directors would be so limited as to curtail even further the availability of competent persons of broad background. The time required in the exercise of their duties would bring the composition of a [Fund] board very close to a purely management group. The benefit of breadth in the directorship would be lost.[22]

d. The proposed involvement of a Fund's Board in selecting the Risk Officer under the Proposed Rule is an inappropriate role for the Board.

Under Proposed Rule 18f-4(a)(3)(ii)(C), in the case of a Fund that is required to adopt and implement a Program, the Fund (*i.e.*, the Fund's Board) will be required to "designate an employee or officer of the fund or the fund's investment adviser (who may not be a portfolio manager of the fund) responsible for administering the policies and procedures incorporating the elements [set forth in the Proposed Rule concerning the implementation of a Program], whose designation must be approved by the fund's board of directors, including a majority of the directors who are not interested persons of the fund." Because Funds typically do not have operational officers or management structures, and the cost of employing a Risk Officer (and attendant staff) would likely be an expense that most Funds would choose not to bear, or, in the case of smaller Funds, could not bear, such designation would likely have to be made by the Fund's Board at the recommendation of the investment adviser and likely would be an employee of the adviser.

Thus the Proposal would put Fund Boards in the position of approving the hiring of and supervising Risk Officers who would likely be operational employees of the investment adviser. That individual would undoubtedly need to have portfolio management skills, even though under the Proposed Rule the individual selected as Risk Officer could not have responsibilities for portfolio management of the Fund.[23] The Risk Officer would be required to "[m]anage the risk associated with the [F]und's derivatives transactions,"[24] and to be "responsible for administering the policies and procedures of the derivatives risk management program . . . ."[25] Although the Proposing Release states that "the *fund* or adviser may

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22 Jaretzki, 792-793.

23 Proposed Rule 18f-4(3)(ii)(c).

24 Proposed Rule 18f-4(a)(3)(B).

25 Proposing Release, p. 221.

determine that they need to hire new personnel to administer the program (emphasis added)"[26], in essence the reference to "fund" means that the Board would be expected to make those personnel selection decisions. I believe that it is inappropriate and undesirable to require Fund Boards to be responsible for the hiring of what are essentially administrative personnel employed by the investment adviser who will have an operational role with respect to a Fund. The investment adviser is better equipped to make that selection, especially since the individual would be an employee of the investment adviser. Since the investment adviser has a fiduciary responsibility to the Fund with respect to portfolio management and compliance tasks, the investment adviser reasonably could be expected to carry out that selection in a responsible manner. Boards have responsibilities under state law to take action if they believe that management is not properly performing its operational responsibilities, but Boards are not expected to make day-to-day business decisions about Fund operations, such as appointing individual business managers employed by the investment adviser.

Placing Boards in the position of approving the hiring of specific management personnel of the investment adviser arguably creates a potential conflict of interest for the Board with respect to its role in assuring that the investment adviser performs its contractual and legal responsibilities in an appropriate manner when the Board has selected the adviser's employee. As an employee of the investment adviser, under typical state employment laws, the Risk Officer's primary duty of loyalty would be to her or his employer.

The Proposed Rule's assignment of this function (approving the investment adviser's hiring of a Risk Officer) to the Fund Board is not comparable to the Board's selection of a chief compliance officer of the fund, who is employed by and responsible to the Board in carrying out his or her responsibilities under Rule 38a-1 of the 1940 Act. This could also set a precedent for future determinations that the Fund Board should have the right to approve the investment adviser's selection of other employees, such as portfolio managers and analysts. That would not only inject the Board into management of the investment adviser's business but would heighten the risks of conflicts of interest. The Fund Board simply should not be in the position of making hiring decisions with respect to the investment adviser's personnel.

e. There does not appear to be a substantial basis for the Commission's positing a potential conflict of interest on the part of a Fund's investment adviser arising particularly from the Fund's use of derivatives.

It appears that the Proposal's assignment to Fund Boards of the responsibilities discussed above is based, at least in part, on the Commission's statement that the requirement to approve a Program would "facilitate scrutiny by the board of directors of the [Program] – an area where there may potentially be conflicts of interest between the investment adviser and the fund with respect to the use of derivatives by the fund."[27] This language is virtually identical, save for the reference to the Program, to language used by the Commission in its Liquidity Risk Management Proposal as a basis to assign approval obligations to the Board.[28] However, as in the case of the Commission's argument in the Liquidity Risk Management

[26] Proposing Release, p. 222.

[27] Proposing Release, p. 226.

[28] *See* Liquidity Risk Management Proposal at p.174.

Proposal that a fund's investment adviser would somehow have an incentive to set a low three-day liquid asset minimum to enhance returns, the only potential conflict of interest posited by the Commission in the Proposing Release to justify the assignment of responsibilities to a Fund's Board to approve a Program is that "there may potentially be conflicts of interest between the investment adviser and the fund with respect to the use of derivatives by the fund."[29] However, the Commission fails to explain that conflict of interest or discuss it at any length, thus providing no basis for the assertion that Board intervention is necessary to approve a Fund's Program. Thus the attempt to analogize this provision of the Proposed Rule to the role Boards have in mitigating potential conflicts of interest between a Fund and its affiliates in principal transactions prohibited by Section 17 of the 1940 Act, for example, is not supported by any discussion and is untenable as a basis for assigning this responsibility to a Fund's Board.

Unlike certain other aspects of fund operations in which the Commission has determined that conflicts of interest necessitate direct involvement by the Board,[30] the supposed "conflict" the Commission cites in explaining its decision to propose direct Board responsibility for approval and oversight of a Fund's Program bears no similarity to the conflicts addressed by other policies typically adopted under 1940 Act Rule 38a-1. The potential conflict cited by the Commission is qualitatively different from the potential abuses that necessitate more direct Board oversight in certain other contexts, such as cross-trades under Rule 17a-7, where an unscrupulous investment adviser could seek to benefit for its own account to the detriment of the fund that is a party to such affiliated transactions.

Since a portfolio manager and the Fund's investment adviser have a fiduciary duty to follow a Fund's stated investment policies and have a legal responsibility to observe the limitations on portfolio management imposed by the 1940 Act and rules adopted thereunder, I do not believe that the investment adviser's design, adoption and implementation of a Program for a Fund raises a potential conflict of interest any more than does the investment adviser's execution of any other portfolio management program it has adopted and implements to seek a Fund's investment objective.

Moreover, I believe that a Fund's Board and the Fund's investment adviser would have a shared focus on the effect of the use of derivatives transactions and financial commitment transactions on Fund performance. In fact, this issue appears to be not so much a conflict of interest as a tension in competing objectives – tensions that an investment adviser must deal with in managing any Fund on a day-to-day basis by assessing whether a particular investment is consistent with the Fund's investment objective(s). Use of derivatives does not present the classic type of conflict of interest in which a Board's role as "independent watchdog"[31] would be implicated, as in the case of approving the Fund's investment management contract, reviewing the use of an affiliated broker (or other transactions between a Fund and its affiliated persons) or the use of Fund assets to finance Fund distribution.

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29 Proposing Release at p. 226.

30 *See, e.g.*, Exemption of Certain Purchase or Sale Transactions Between a Registered Investment Company and Certain Affiliated Persons Thereof, 45 Fed. Reg. 29,067 (May 1, 1980) (proposing amendments to Rule 17a-7) (explaining that "an unscrupulous investment adviser might 'dump' undesirable securities on a registered investment company" and that, "the first line of responsibility for determining compliance with the proposed amendment" to Rule 17a-7 "should be with each investment company's directors").

31 *See* Note 10, *supra*.

Consistent with this view, I believe that the final rule should be premised on the assumption that the Board's oversight of a Fund's Program should be the same as that applicable to other areas of Fund operations, not on the basis of the existence of a supposed conflict of interest between the Fund and its investment adviser that the Proposing Release has failed to articulate adequately.

f. The primary derivatives management responsibilities the Proposed Rule would assign to Fund Directors should be assigned to a Fund's Investment Adviser.

A Fund's investment adviser is likely to have more extensive expertise with respect to the nature of derivative investments and financial commitment transactions than the Fund's Board, and is more likely to have the professional, expert staff and operational infrastructure to perform the design, implementation, monitoring and compliance responsibilities contemplated by the Proposal. The investment adviser of a Fund using derivatives and financial commitment transactions could be tasked with periodically reporting to the Board about a Fund's use of derivatives and financial commitment transactions and whether such use complies with the policies and procedures designed by the investment adviser to govern their use, just as investment advisers typically report to Fund Boards about the implementation of other Fund investment policies designed to achieve a Fund's investment objective.[32]

In the Proposing Release, the Commission asks whether it is appropriate to require the designation of a specific person as the Risk Officer, and whether the Proposed Rule should allow the Fund to designate the investment adviser as a whole or a risk committee as the Program's risk manager.[33] In requiring Fund Boards to approve the designation of the Fund's Risk Officer under the Proposed Rule, the Commission has taken a different approach than it took in the Liquidity Risk Management Proposal for the adoption of proposed Rule 22e-4(b)(3)(iii), in which the Commission would at least expressly allow a Fund's Board to designate the Fund's investment adviser *or* officers (who may not be solely portfolio managers of the Fund) responsible for administering the Fund's liquidity risk management program.[34] The Commission's more pragmatic approach under the Liquidity Risk Management Proposal allows the Board to make such delegation to the investment adviser, and comports with the Commission's understanding that it would be "consistent with the way we understand most funds currently manage liquidity."[35] Curiously, the Commission did not take a similar approach in the Proposing Release with respect to approval of a derivatives risk management Program, and does not even explain why it believes this different approach is necessary or appropriate in the case of a Fund's use of derivatives. It is difficult to posit from the perspective of portfolio management oversight what it is about a Fund's use of derivatives that is fundamentally different than the Fund's management of its liquidity such that the Commission finds it necessary or appropriate to require the Board to designate an individual as Risk Officer to oversee the Program, rather than allowing the Board to have the ability to delegate that responsibility to the

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32 In the case of certain "internally- or self-managed funds" that do not employ an investment adviser, these functions are typically performed by portfolio personnel employed by the fund, and the roles that the undersigned proposes in this letter to be assigned to a Fund's investment adviser would apply to those internal managers.

33 Proposing Release, at p. 223.

34 Presumably, that alternative would allow the Board of an internally-managed fund to designate the employees of the investment adviser who act as officers of the Fund to serve in that capacity.

35 Liquidity Risk Management Proposal, at p. 177.

investment adviser. Based upon my own observations of how Funds operate, it is likely that the management of derivatives risks of Funds is currently housed in the Fund's investment adviser in the same manner as a Fund's liquidity risk management process is.

The Proposed Rule could be revised in that vein to reassign to the investment adviser the direct operational role that, as currently drafted, the Proposed Rule would assign to Fund Boards. If the Commission decides to proceed with adopting a prescriptive rule, rather than adopting a narrower rule and issuing guidance on Funds' use of derivatives, I urge the Commission to consider re-crafting the Proposed Rule to clearly stating that a Fund's Board may delegate to the Fund's investment adviser the primary responsibility for the design, implementation and monitoring functions with respect to the Fund's use of derivatives transactions and financial commitment transactions.

Under that approach, the Board would have what is an appropriate oversight role in which it would receive periodic reports from the investment adviser about the investment adviser's performance of those functions. The investment adviser's reports would be supplemented and complemented by reports from the Fund's CCO under Rule 38a-1 under the 1940 Act on the operation of the policies and procedures designed to prevent violations of the final version of Rule 18f-4 by the investment adviser and the Fund. That approach would, I believe, better align the Board's role under the Proposed Rule with the traditional oversight role of a Board under the 1940 Act and with the responsibilities traditionally assigned to directors under applicable state laws. It would also separate an operational responsibility (on the part of the Risk Officer) from a compliance "control" responsibility that is more appropriately assigned to a Fund's CCO.

I suggest this approach because of concerns, as stated above, about the nature and extent of responsibilities that the Proposed Rule would place upon a Fund's Board, especially in light of the Commission's proposed assignment of substantial additional responsibilities to Fund Boards under the Liquidity Risk Management Proposal.[36] I believe that the responsibilities under the Proposed Rule with respect to a Fund's use of derivatives and financial commitment transactions would be better implemented by a Fund's professional investment advisory personnel than by its Board.

The determination whether a Fund should use derivatives and financial commitment transactions to seek a Fund's investment objective is an appropriate decision for a Fund Board to make, much as it approves the Fund's investment objective(s) and general description of the Fund's investment policies set forth in its registration statement. However, the remaining tasks that would be assigned to a Fund's Board under the Proposed Rule represent operational and portfolio management functions. I believe that those responsibilities could properly and more effectively be placed on the Fund's investment adviser, since the investment adviser has or should have greater expertise than a Fund's Board is likely to have with respect to the analysis of the highly technical nature and portfolio function of derivatives and financial commitment transactions. Thus, the investment adviser would be better positioned to carry out that responsibility than the Board.

2. The Proposed Rule does not clearly explain the relative legal and operational roles of a Fund's Risk Officer, Chief Compliance Officer and liquidity risk manager and how they should interrelate.

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36 *See* the NYC Bar Liquidity Risk Management Proposal Comment Letter, at note 18 *supra*.

Under the Proposal, the Board of a Fund that is required to adopt and implement a Program would be required to approve the Fund's designation of the Fund's Risk Officer.[37] While the Proposing Release states that the Risk Officer may "also have other roles, including, for example, serving as the fund's chief compliance officer or chief risk manager (if it has one)"[38], the Proposal provides no guidance or explanation as to how that would work from a legal or practical perspective. Also absent is any guidance as to how the Risk Officer's role might interface with that of a Fund's chief liquidity risk manager, a position that will be required if the Commission's Liquidity Risk Management Proposal is adopted.

Of particular concern in assessing the blurring of compliance roles that would occur under the Proposed Rule is the requirement of Proposed Rule 18f-4(a)(3)(ii)(B) that the Risk Officer must prepare and submit to the Fund's Board a written report "that describes the adequacy of the [P]rogram and the effectiveness of its implementation." No explanation is provided as to how this function complements or differs from the requirement of Rule 38a-1(3) which requires that a Fund "[r]eview, no less frequently than annually, the adequacy of the policies and procedures of the fund and of each investment adviser, principal underwriter, administrator, and transfer agent and the effectiveness of their implementation," or the requirements of Rule 38a-1(a)(4)(iii) pursuant to which the Fund's Chief Compliance Officer must at least annually provide a written report to the Board on "[t]he operation of the policies and procedures of the fund and each investment adviser, principal underwriter, administrator, and transfer agent of the fund, any material changes made to those policies and procedures since the date of the last report, and any material changes to the policies and procedures recommended as a result of the annual review conducted pursuant to paragraph (a)(3) of this section." This overlapping and potentially conflicting set of roles of the Chief Compliance Officer and the Risk Officer is not explained or rationalized in the Proposal. At best, it could produce redundant reports that would waste Board time and management resources; at worst it could produce Boardroom "turf" encounters between the CCO and the Risk Officer that would make the meeting of the Sharks and the Jets in "West Side Story" look like a genteel gavotte.

In the Liquidity Risk Management Proposal, the Commission determined that the investment adviser or officers, and not the chief compliance officer, of a fund covered by that proposal must be designated as responsible for administering the fund's liquidity risk management program, and that it would task persons in a position to manage a fund's liquidity risks on a real-time basis with responsibility for administration of the liquidity risk management program[39]. However, under the Proposal, the Commission has stated that because some small advisers have a limited number of employees or officers who are not portfolio managers of a fund, in that case the Fund's Chief Compliance Officer could be designated as the Risk Officer of the Fund.[40] The Proposal then notes that unlike Rule 38a-1, Proposed Rule 18f-4 would not require that the Risk Officer only be removable by the Board.[41] That raises an interesting question as to what the Commission expects would happen if the investment adviser decides to

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37 Proposed Rule 18f-4(a)(3)(ii)(C).

38 Proposing Release, p. 222.

39 Liquidity Risk Management Proposal Proposing Release, 80 Fed. Reg. at 62,324.

40 Proposing Release, p. 222.

41 Proposing Release, p. 223.

fire its employee who serves as both Risk Officer and as CCO of a Fund. The answer may require the wisdom of Solomon. This suggests that it would be preferable to leave the Board out of the process of designating a Risk Officer altogether.

It is also not clear under the Proposal whose decision (the liquidity risk management officer's, the Risk Officer's or the CCO's) "trumps" the others in certain circumstances entailing conflicting views; for example, it is not clear whose view would or should prevail in a circumstance involving the utilization of a derivative instrument that the Risk Officer says is appropriate for the Fund's portfolio but which the liquidity risk officer claims (perhaps with disagreement by the Risk Officer as to the assessment of liquidity made by the liquidity risk management officer as to the instrument) would violate the Fund's liquidity requirements, leaving the CCO to decide whether the CCO would determine that the use of such instrument constituted a material compliance violation. Perhaps that type of issue is outside the scope of the Commission's rulemaking intent, but it should be noted that the complexities for Boards and investment advisers resulting from the Commission's rules creating competing "compliance" functions are not insignificant.

It is also unclear how a dual-hatted CCO/Risk Officer would separate her/his responsibilities under Rules 18f-4 and 38a-1. In the case in which the same person has both such roles, it is unclear from the Proposal how the CCO's obligation under Rule 38a-1 to review the operation of the policies and procedures of a Fund, which would include its Program, could be fulfilled in an independent manner when the CCO also functions as the Risk Officer responsible for administering the policies and procedures of the Program under Proposed Rule 18f-4. Also, as noted above, requiring the Fund's Board to review a written report, at least quarterly, from the Risk Officer, that reviews the adequacy of the Fund's Program and the effectiveness of its implementation, makes the Risk Officer responsible for reviewing and "certifying" the adequacy of her/his fulfillment of his/her job requirements. When the CCO and the Risk Officer are the same person, the potential conflicts of interest inherent in the two roles virtually twist one's mind.

I respectfully submit that the Proposed Rule's approach in having the person (the Risk Officer) who is responsible for implementing an operational control function such as derivatives risk management oversight also be responsible for assessing the effectiveness of that operational process she or he oversees is not a "best practice." It is well recognized in the fields of internal audit and compliance that there should be a separation of functions such that the quality of operational controls is not assessed by the same person or even the same department as that which performs the functions being evaluated. I suggest that such function could be assigned to the CCO for purposes of reporting to the Fund's Board pursuant to Rule 38a-1. With respect to evaluating the investment adviser's implementation of a Program, I believe that a proper functional department would be the investment adviser's Chief Compliance Officer, as required under Rule 206(4)-7 under the Investment Advisers Act of 1940.

I believe that policies and procedures required under Proposed Rule 18f-4 would be subject to the requirement of Rule 38a-1 that they be "policies and procedures reasonably designed to prevent violation of the Federal Securities Laws by [a] fund, including policies and procedures that provide for the oversight of compliance by each investment adviser . . . of the fund."[42] However, because of the operational nature of the policies and procedures attendant to the administration of a Program and because the characteristics and requirements of such Program would entail day-to-day investment management functions that are not the types of responsibilities appropriate to assign to a Chief Compliance Officer, I

[42] *See* 17 C.F.R. § 270-38a-1 (2015).

believe that the responsibility for the implementation of a Program should be that of an employee or employees of the Fund's investment adviser, not that of the Chief Compliance Officer.

I also believe that requiring the Fund's investment adviser to adopt and implement a Program, with oversight by the Fund Board through the Rule 38a-1 process, is an approach that more appropriately assigns oversight responsibilities, not managerial and operational responsibilities, to Fund Boards and their CCOs in connection with the adoption and implementation of Programs, and would be consonant with the statutory responsibilities of Directors and the requirements of Rule 38a-1.

3. The Commission should evaluate whether the compliance costs likely to be associated with implementation of the Proposed Rule would create "barriers to entry" for sponsors of new funds.

As the Commission noted in assessing the costs and benefits of the Proposed Rule, one of its important considerations in proposing any rule is the rule's possible effect on capital formation.[43] I respectfully suggest that the adoption of the Proposed Rule may create or exacerbate "barriers to entry" for new or small investment advisers and fund sponsors hoping to create funds that may utilize derivatives as part of their portfolio strategy. For example, the Commission recognizes that the requirement in the Proposal that a Fund designate an employee or officer of the Fund or the Fund's investment adviser as the Risk Officer "would effectively bar funds from outsourcing the administration of the derivatives risk program to third parties."[44] That statement tacitly recognizes the additional costs that would be imposed on Funds or their investment advisers under the Proposal, which, in effect, will be an incremental cost barrier to the creation of new investment companies by individuals and entities having less access to capital than larger, established firms. As noted above in my comment 1, above, the additional costs resulting from of a Board's retaining independent consultants to survey and report on industry practices to support the Board's decision whether to approve a Program or any material changes to it may also be a substantial cost burden for smaller funds and fund complexes.

In Section IV.D. of the Commission's Economic Analysis of the Proposal in the Proposing Release, the Commission attempts to analyze the projected general costs and benefits of the Proposed Rule, such as the effects of the Proposed Rule on efficiency, competition and capital formation. It also attempts to quantify specific projected costs (other than general benefits and costs such as effects on efficiency, competition and capital formation) that would result from the adoption of the Proposal. To do so, it looks at specific aspects of operations of Funds that would be affected by implementation of the Proposed Rule, such as the costs of implementing and maintaining an exposure-based Portfolio Limitation (including a test for VaR), the costs of initiating and maintaining an asset segregation/coverage program (for derivatives and financial commitment transactions), and the costs of implementing and maintaining a derivatives risk management Program. These topics are discussed below.

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43 Proposing Release, p.262.

44 Proposing Release at p. 224.

a. There should be further dialog about the effect of Portfolio Limitation requirements of the Proposed Rule that would effectively cause certain funds to restructure or cease operations. The Proposing Release does extensively address the projected costs and other effects of the Proposed Rule on certain types of existing Funds whose very existence would be challenged if the Proposed Rule is adopted in its current form. The Proposing Release notes that certain existing "alternative strategy funds" and leveraged ETFs might not be able to comply with the conditions of the Proposed Rule to enable them to continue operating as open-end investment companies while following their current investment strategies. That could appear to some as a not-so-subtle attempt by the Commission to prohibit certain types of derivatives-focused investment strategies for existing open-end funds, as well as in open-end funds not yet established.[45] Indeed, the Proposing Release notes that the analysis conducted by the Commission's DERA Staff[46] found that certain "managed futures funds" operating as open-end investment companies had exposure to derivatives ranging from 500% to 950% of net assets, and that Funds "that have exposures substantially in excess of 300% of net assets would not appear to be able to satisfy the VaR test in any event . . . ."[47]

In the Proposing Release, the Commission commented that Funds "that use derivatives more extensively have derivatives notional exposures that are substantially in excess of the funds' net assets, with notional exposures ranging up to almost ten times a fund's net assets. These highly leveraged investment exposures appear to be inconsistent with the purpose and concerns underlying section 18 of the Act (footnote omitted."[48] Elsewhere, the Commission notes that certain "alternative strategy funds" and leveraged ETFs that hold only cash equivalents and derivatives "would not be able to satisfy the VaR test

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45 "Directors should also be asking themselves whether they understand any links that may exist between liquidity and valuation with respect to the funds they oversee and whether directors are appropriately focused on funds with strategies that may be more likely to face liquidity challenges. More broadly, advisers and fund boards should carefully consider whether an open-end fund's investments and investment strategy are appropriate for a fund offering daily redemptions." White Speech, note 10, at p. 3. "Second, the events of last December have led me to spend some time thinking about the contours of the open-end fund structure. Some have expressed the view that certain assets are simply too illiquid to be held in large concentrations by open-end funds. Under such an assumption, I believe certain investment strategies—such as those focused heavily on distressed debt—may be more suitable as closed-end or private funds, rather than as funds that are subject to daily redeemability. I think this issue is one that fund management and boards ought to weigh carefully. This issue also highlights for me how important it is for funds to implement robust policies and procedures to ensure that their investment strategies are appropriate for an open-end structure, both at a fund's inception and throughout the life of a fund. I would encourage fund management and boards to view the events of last December as an invitation to revisit the adequacy of their own protocols for vetting new funds that will be subject to daily redeemability (footnote omitted)." David W. Grim, Director, SEC Div. of Invest. Mgt., "Remarks to the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference," Orlando, FL, Mar. 14, 2016.

46 SEC Div. of Economic and Risk Analysis, "Use of Derivatives by Investment Companies," Dec. 2015, avail. at www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf.

47 Proposing Release, p. 147-148.

48 Proposing Release, p. 27.

[under Proposed Rule 18f-4].”[49] The Commission further notes that such use of derivatives where a Fund has future payment obligations raises questions about asset sufficiency: *i.e.*, the ability of the Fund to maintain sufficient assets and liquidity to meet its obligations. Essentially, that represents the Commission’s view that such funds either have to merge into another fund that meets the requirements of the Proposed Rule, deregister with the Commission and cease operations, or change their format to a private fund structure or a public or private commodity pool.[50] Although some of the estimated costs of deregistration or conversion are set out in the economic analysis section, the effects on future capital formation of essentially prohibiting open-end funds that utilize such investment strategies are not discussed in the Proposing Release, except as an “opportunity cost” for investors if such funds become unavailable to investors or available only at a higher cost. The Commission does not attempt to quantify the potential loss of income to such funds’ investment advisers, should the Funds they manage deregister and cease to exist, or the possible loss of jobs by employees of such investment advisers.

Aside from the question whether the investment exposure offered by derivatives was the type of “leverage” that underpinned the concerns of Congress (and the Commission) in proposing the inclusion of Section 18 in the 1940 Act, [51] the concerns of the Commission about the utilization of the open-end format for investment strategies that pose substantial concerns about the ability of the funds employing them to satisfy their obligations to redeem up to 100% of their shares on a daily basis is a discussion worth having. However, rather than using the Proposed Rule as the means to force the restructuring or cessation of operation of certain types of alternative strategy funds and leveraged ETFs that would be most severely affected by the Proposed Rule, perhaps a better way to foster discussion of the issues entailed in the use of derivatives strategies of the types employed by such funds would be a Commission-sponsored Roundtable on the future of the use of these types of strategies (and other strategies posing liquidity challenges to open-end funds) in different categories of investment companies.

b. The projected costs of compliance with the Proposed Rule identified by the Commission could effectively bar many new entrants from offering Funds using derivatives. While the Commission’s approach in analyzing the costs and benefits of implementing the Proposed Rule devotes considerable thought to the effects on *existing* Funds, there is little, if any meaningful analysis in the Proposing Release of the effects of the costs of compliance with the Proposed Rule on the creation of *new* Funds or on *new* investment advisers seeking entry into the capital markets. For example, the Commission’s analysis notes that a substantial new cost of compliance with the Proposed Rule would be the establishment of a derivatives risk management Program:

> There is currently no requirement for funds that invest in derivatives to have a risk management program with respect to derivatives transactions, although we understand

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49 Proposing Release, note 223, p. 111.

50 Proposing Release, p. 289.

51 In particular, Section 18(g) of the Act in pertinent part defines “senior security” as any “bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends.” While some practitioners have questioned whether the intent of Congress in drafting Section 18 applies to the use of derivatives, the undersigned does not take up that issue herein.

> that the advisers to many funds whose investment strategies could entail derivatives already assess and manage the risks associated with derivative transactions. Funds' current risk management practices may not meet the proposed rule's specific risk-management requirements, however, and therefore we believe that the baseline for the derivatives risk management program requirement would be that all funds that would be subject to the requirement would need to establish such a program or conform their current practices to satisfy the requirements in the proposed rule.[52]

The analysis has the effect of skewing the discussion of the effects of compliance with the Proposed Rule to the effects on *existing* Funds, which have already created a capital base, through the sale of shares, that could support additional costs, and while it is important to consider such effects, it may cause the analysis to understate or deflect attention from the effect of the Proposed Rule on the ability of new entrants to the capital markets to create funds that would use derivatives to the extent that would require compliance with the provisions of the Proposed Rule for developing a Program.

As noted above, a significant issue raised by the Proposed Rule is its possible effects on capital formation that could be posed by the potential barriers to entry that would be created by the sheer costs of compliance with the Proposed Rule. That concern is not unfounded, based on an analysis of the data compiled by the Commission's Staff as set forth in Section IV.D. of the Proposing Release. The data includes estimates of specific costs of implementing (1) exposure based Portfolio Limitations, (2) establishing and maintaining an asset segregation program for derivatives and an asset coverage program for financial commitment transactions, and establishing and maintaining a derivatives risk management Program.

The chart below shows the Commission's data for the "high end" of such cost estimates, since the Proposing Release states that a Fund that is part of a fund complex is likely to benefit from economies of scale and would incur costs closer to the "low end" of the estimated range of costs shown in the analysis, while the high end of such estimates represents projections of costs likely to be borne by a stand-alone fund. For purposes of showing the possible creation of barriers to entry posed by the Proposed Rule, I have assumed that a new entrant to the industry that intends to use derivatives would likely be a "stand-alone" fund rather than part of a larger fund complex. I have not conducted an independent analysis or survey as to such costs, but believe that the estimates provided by the Commission's Staff for the aspects of implementing and maintaining a Program shown in the chart would be daunting economic challenges for anyone seeking to establish a new fund engaging in the use of derivatives to a substantial degree requiring the establishment of a Program. The Commission's (high-end) cost estimates for compliance with the Proposed Rule by a new stand-alone fund using derivatives in a manner requiring the adoption of a Program (but excluding use of financial commitment transactions) and using a third-party service provider to prepare and file reports on Form N-PORT are set forth in the following chart:

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[52] Proposing Release, p. 273.

Cost Category	Cost of Establishing Metric	Annual Ongoing Compliance Cost
Establishing exposure-based portfolio limit (150%) or risk-based limit (300%)	$150,000	$45,000
Establishing VaR test under Risk-Based Portfolio Limit (300%)	$180,000	$54,000
Asset segregation Program	$75,000	$56,250
Risk Management Program	$500,000	$375,000
N-PORT Reporting (3d Party)	$2,319	$1,517
Total	$907,319	$531,767

Undertaking a "prelaunch" cost expenditure of nearly $1 million merely to start a fund focusing on derivatives and having an annual ongoing compliance cost in excess of $500,000 would require that an investment adviser/sponsor have very deep pockets and be willing to advance such costs in the hope of raising a sufficient amount of capital to enable eventual recoupment or that the sponsor has a firm expectation of the ability to raise a sufficient amount of capital in an initial launch of the Fund to cover such expenses. These costs do not take account of the other pre-launch costs of starting up a Fund, including the initial seed capital (which must be an amount sufficient to enable the Fund to operate its investment program), legal costs, SEC registration costs, blue-sky expenses and auditing costs, among others. The effect of the amount of costs that would be required to be expended under the Proposed Rule would likely be an effective barrier to the launch of a new fund by a small, independent investment adviser, and frankly would pose substantial costs even for established investment advisers of existing fund complexes.

Moreover, the cost estimates in the Proposing Release prepared by the Commission's Staff are very narrowly focused and do not address all of the significant costs of implementing and maintaining compliance with the Proposed Rule. The Staff's estimated costs cover (i) developing policies and procedures to comply with the Proposed Rule's requirements for establishing Portfolio Limitations, including implementing a VaR test, and for implementing asset segregation programs, (ii) planning, coding and testing systems modifications (as opposed to creating new systems in the case of new registrants) for implementing VaR requirements and asset segregation requirements, and (iii) preparing, training materials and holding training sessions for "staff in affected areas."[53] In the case of the establishment and maintenance of a Program, the Staff's cost estimates are similarly based on estimates only for (i) developing policies and procedures (including the designation of the Risk Officer), (ii) integrating and implementing the procedures and (iii) preparing training materials and holding training sessions for "staff in affected areas." In a similar manner, the ongoing cost estimates focus only on estimated costs of verifying the operation of the systems, systems maintenance and additional staff training (and, in the case of maintaining a Program, the costs of the Risk Officer).

Significantly, the Proposing Release does not set forth any estimates of costs that Fund Boards might be expected to incur in (a) retaining legal counsel and/or consultants to advise them of their responsibilities under the Proposed Rule in adopting derivatives policies and procedures and ongoing monitoring of them,

[53] Proposing Release, pp. 307, 314.

including review of Fund disclosure documents and procedures and ascertaining “best practices” by other funds, and (b) costs of training Board members about the technical aspects of derivatives that Board members would need to understand to be able to carry out their responsibilities in a competent manner. There is similarly no estimate of costs a Fund might incur in revising and maintaining disclosure documents with respect to changes necessitated by the Proposed Rule. Indeed, the Proposing Release is relatively silent on this point.

In the Proposing Release, the Commission notes that the requirement that a Fund’s Risk Officer be an employee of the Fund or the investment adviser “would effectively bar funds from outsourcing the administration of the derivatives risk management function to third parties”[54] and asks whether that is an appropriate approach, or whether instead the Proposed Rule should allow third parties to administer such Programs as some Funds and investment advisers do with respect to their CCOs. The Proposing Release offers no explanation for requiring the Risk Officer to be an employee of the Fund or the investment adviser. In fact, the Proposing Release notes that the Risk Officer might have other roles, such as serving as the Fund’s CCO or chief risk manager, and that since some “small” advisers may have a limited number of employees or officers who are not portfolio managers, the CCO might be designated as the Risk Officer or the investment adviser might determine to hire new personnel to administer the Program.[55] Use of third-party specialists in this function could provide both a more economical way for a small fund adviser to gain a sufficient level of expertise in the construction and management of the Fund’s Program rather than hiring new personnel or designating as Risk Officer the Fund’s CCO (who might not have the level of technical expertise to act in such role as Risk Officer and whose functioning in that capacity could raise conflicts of interest, as discussed herein). Third-party administrators are likely to provide the measure of independence that the Commission says is important for a well-functioning program and are likelier to have the resources and capability to develop more sophisticated computer programs and processes in this area than a new investment adviser for a new Fund. The Commission should give strong consideration to allowing Funds to designate third-parties to fulfill their derivatives risk management obligations.

All in all, the costs of compliance with the Proposed Rule will pose significant barriers to entry for new funds that propose to offer a derivatives strategy to investors and the Proposing Release does not adequately acknowledge or address that issue. I respectfully suggest that the Commission re-address that issue before adopting the Proposed Rule.

4. There are several terms used in the Proposed Rule that lack clarity or definitional reference and that could lead to substantial variance in the manner in which the Proposed Rule is interpreted and applied by different Funds.

Unlike other definitions used in the Proposed Rule [for example, “notional amount” (Proposed Rule 18f-4(c)(7)) and “exposure” (Proposed Rule 18f-4(c)(3), whose definitions and application are clear and not readily susceptible of subjective application or interpretation], the term “value-at-risk” (“VaR”) is

54 Proposing Release at p. 224.

55 Proposing Release, p. 222.

defined in very general terms under the Proposed Rule, and the phrases "stressed market conditions"[56] and "confidence level" in Proposed Rule 18f-4 lack any definition or descriptive parameters in the Proposed Rule or the Proposing Release issued by the Commission. Those undefined terms, which are susceptible of widely-varying interpretation, should not be the basis of a compliance responsibility for which a Fund, its Board and its investment adviser may incur regulatory or legal liability. If they are retained in the final version of the rule, I have a high confidence level they will cause undue stress to Fund Boards and investment advisers.

Arguably, unlike the term "VaR," which at least has some reference in academic literature, those latter two terms do not, to my knowledge, have any universally-agreed upon meaning and parameters. As a result, they are likely to be interpreted and applied in different ways by different funds and investment advisers based upon their subjective judgment and understanding. This rule-drafting approach appears to reflect an effort by the Commission to incorporate a "principles-based" philosophy with respect to certain terms in combination with other highly-prescriptive and specific language and definitions of other terms in the Proposed Rule. I do not believe that such a "principles-based" approach to rule-making by the Commission in this manner is desirable, because Funds and Boards may incur potential liability for alleged compliance violations with respect to implementation of policies and procedures based on the interpretation of such loosely-defined or undefined terms if the Commission's staff challenge the decisions made by Fund Boards and investment advisers in inspections by OCIE or in administrative proceedings undertaken by the Commission enforcement staff, and potential civil liability in actions brought by the litigation bar seeking to exploit such ambiguities.

As noted, the Proposed Rule is an odd combination. on the one hand, of highly specific portfolio limitations (for example, the 150% and 300% percentage limits specified in the Proposed Rule for compliance with the respective exposure-based and risk-based Portfolio Limitations) and, on the other hand, requirements based on very generally-defined terms, such as the mandate to use a "VaR" measurement that takes account of the full portfolio and of the securities portfolio (in the case of the strictures for a Fund's compliance the exposure-based 300% Portfolio Limitation in Proposed Rule 18f-4(a)(1)(ii)). While Rule 18f-4(c) contains very specific definitions of a number of terms used in the Proposed Rule, the term "VaR" is defined in subsection (c)(11) of the Rule in very general terms as "an estimate of potential losses on an instrument or portfolio, expressed as a positive amount in U.S. dollars, over a specified time horizon and at a given confidence level" with the proviso that a Fund must apply its VaR model consistently. Under the Proposed Rule any VaR model must take into account and incorporate all significant, identifiable market risk factors associated with a fund's investments, including, a list of general risks attendant to securities markets investing, "material risks form the nonlinear price characteristics of a fund's investments, including options and positions with imbedded optionality" and the "sensitivity of the market value of the fund's investments to changes in volatility." No guidance is provided as to what the Commission intends with respect to determining a "confidence level." One could reasonably argue that such non-specific language is "quant" jargon and that its use does not represent clear rule-drafting. That type of language will certainly cause Fund Boards substantial concerns about how to apply and interpret those terms when reviewing a Fund's Program; that imprecise language may also provide many tempting opportunities to the litigation bar.

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56 The Commission does ask, in the Proposing Release at pp. 175-176, whether the term "stressed conditions" is clear and whether there is a better alternative.

Subsection (a)(3)(i) of the Proposed Rule, which sets forth the requirements for the elements of a derivatives risk management Program, includes the requirement that the Fund review and update the Program at least annually, including any VaR calculation models used by the Fund during the period of the review. The Fund's use of VaR calculations is also incorporated specifically in the record-keeping requirements of the Proposed Rule, giving rise to another area of potential exposure for Funds if the Commission Staff, for example, disagrees with the appropriateness of the Fund's models or its approach to the calculation and measurement of VaR.

The Commission states that it believes that the definition of VaR used in the Proposed Rule "is generally consistent with definitions of VaR that are used in other regulatory regimes as well as in academic literature."[57] However, presumably Funds and Fund Boards are responsible to follow, and the enforcement staff of the Commission is responsible for enforcing, Commission rules and federal securities laws, not the contents of academic literature. Moreover, as the Commission notes in the Proposing Release, there are three basic approaches to calculating VaR (with numerous variations within each approach): the variance-covariance method, the historical simulation method, and the Monte Carlo simulation method. This means that under the Proposed Rule, different Funds could employ different VaR calculation methods than other Funds having similar portfolios and investment strategies. Each approach to measuring VaR has its own shortcomings. For example, the variance-covariance approach requires one to make high-conviction assumptions about the return distribution of standardized assets; the historical simulation approach assumes that the data used is a representative sample of future risks; and the Monte Carlo simulation requires highly complex computational methodologies. Because the results of each approach depend on their inputs, the application of different VaR calculation methodologies can produce different results using similar factors.

I do not propose to offer any view on which approach is "best" or "appropriate" for derivatives risk-management compliance purposes: that is beyond my professional competence, and, in any event, it is not necessary to do so to make the point that the Commission is incorporating into a compliance rule a factor that may not be interpreted or applied by all regulated entities in the same manner and which could produce very different results for similar portfolios. These approaches may be applied to the same derivatives transactions in a very different manner by different funds and advisers. How is a Fund Board supposed to evaluate competently the appropriateness of a particular approach to VaR proposed to be incorporated in a Fund's Program? By not mandating the use of a particular methodology to calculate VaR, the Commission is implicitly suggesting that it cannot determine what is the best or most appropriate model to use for regulatory oversight purposes. All of this points to the inappropriateness of including such technical, undefined processes as the basis of a compliance rule of general application to investment company registrants. It might be more appropriate to include discussion of such terms in guidance issued by the Commission expressing its views on some of the factors a Fund's investment adviser might consider in managing the Fund's use of derivatives.

As noted, the term "stressed market conditions" in the definition of "risk-based coverage amount"[58] is not defined by any parameters or other explanation and is susceptible to widely-divergent interpretations as to its meaning. If the Commission intends to provide subjective latitude to Funds and their investment

[57] Proposing Release, p. 119.

[58] Proposed Rule 18f-4(c)(9).

advisers in interpreting and applying this and other terms in the Proposed Rule, at the very least the language of the Proposed Rule should clarify that each of those terms shall be "as interpreted in good faith by the investment adviser in implementing the Fund's derivatives risk management Program and the Fund's overall investment program."

I am equally concerned by the Commission's requirement in the proposed amendment to Item C.11.c.vii in Form N-PORT to require the reporting fund to provide "gamma" and "vega." The instructions to the Form lack any definition of or explanation as to the Commission's intended meaning of those terms for its reporting purposes. While I assume that the reference to "gamma" relates to the rate of change for delta with respect to the underlying asset's price in the case of derivatives, I note that "gamma" has at least 25 other "common" meanings, ranging from the Lorentz factor in the theory of relativity to specific weight in mechanical engineering; I suspect that "vega" is intended to refer to an option's sensitivity to changes in the volatility of the underlying asset rather than to the defunct compact automobile offered by General Motors in the 1970s. Feeble attempts at humor aside, I believe that it is necessary and desirable that a Commission-mandated reporting form should clearly tell Funds and their investment advisers exactly what the Commission means to have them report and not to assume that all market participants interpret those highly technical terms in the same manner, especially where there is potential liability for failure to file accurate reports with the Commission. The absence of definitions of these terms in the Proposed Rule and proposed amendments to Form N-PORT can also lead to uncertainty as to the manner in which the Commission and its staff will view the attempts by funds and advisers to apply those terms, when such funds and advisers are examined or subjected to administrative proceedings.

5. The Proposal provides no guidance as to the effect of a Fund's use of derivatives on its compliance with 1940 Act requirements as to "diversification" and "concentration."

In its comprehensive and highly-insightful 2011 Concept Release[59] on derivatives, the Commission sought comment on how the use of derivatives by investment companies implicated certain provisions of the 1940 Act. In particular, the Concept Release posed the issue facing many funds in determining how to apply the strictures of the 1940 Act with respect to portfolio security issuer diversification and concentration of investments. As the Commission noted, "[g]iven that derivatives generally are designed to convey a leveraged return based on a reference asset over a period of time, their mark-to-market values at a given point do not reflect the asset base on which future gains and losses will be based or otherwise represent the potential future exposure of the fund under the derivatives investment."[60]

The Concept Release noted the dilemma faced by funds in certain cases in identifying the "issuer" of a derivative: whether the counterparty to the transaction or the issuer of the reference asset should be deemed to be the "issuer" for the purposes of a fund's diversification testing.[61] However, neither the Proposing Release nor the Proposed Rule addresses these questions. Likewise, the Proposal does not address the questions raised in the Concept Release with respect to the application of Section 12(d)(3) of

59 Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776 (Aug. 31, 2011) (the "Concept Release").

60 Concept Release, at 52.

61 Id., at 53.

the 1940 Act and the provisions of Section 8(b)(1) of the 1940 Act with respect to concentration in an industry or group of industries. Because of the silence of the Proposing Release on those critical questions, they remain unresolved for Funds, Boards and investment advisers, with the result that different Funds and investment advisers will continue to interpret and apply these concepts in different ways. I respectfully suggest that further guidance from the Commission on these points is highly needed.

6. The Commission's goals could be accomplished better by (a) modifying the language of the Proposed Rule to eliminate specific portfolio management requirements for Funds and to remove the provisions assigning portfolio managerial decision-making to Fund Directors and (b) issuing updated guidance containing the Commission's views on the use of derivatives and financial commitment transactions.

I believe that it is appropriate to ask a Fund's Board to approve whether a Fund will use derivatives transactions and financial commitment transaction to seek its investment objective, to assure adequate disclosure of such policies, and to provide appropriate oversight of the manner in which the Fund's investment adviser designs and implements policies and procedures for such an investment program, with appropriate periodic reporting by the investment adviser to the Board and oversight by the Fund's Chief Compliance Officer with respect to the implementation of those policies and procedures. That approach is consistent with the oversight role assigned to Directors under state law as well as under other provisions of the 1940 Act and the rules adopted by the Commission thereunder. It is an appropriate role for Fund Directors since they must approve, and in fact sign, the registration statement of a Fund, containing the Fund's investment policies that the investment adviser will be responsible for implementing and complying with in managing the Fund's assets.

Overall, the Commission has proposed what I respectfully suggest is an unworkable approach to the use of derivatives and financial commitment transactions by Funds by proposing a highly granular, prescriptive rule that would (a) dictate the manner of performance of specific portfolio management activities and the application of portfolio investment techniques using undefined or vaguely defined standards (*e.g.* the use of VaR calculation models), (b) mandate ta Fund Board's exercise of managerial judgment in designing and implementing a Fund's derivatives risk management program and in selecting the personnel responsible for the implementation and oversight of portfolio risk management activities for a Fund's use of derivatives (*i.e.,* the appointment of a Risk Officer), (c) assign functional and managerial responsibilities for a Fund's compliance with such requirements to the Fund's Board, rather than delegating that responsibility to the Fund's investment adviser, and (d) create or exacerbate barriers to entry for new funds seeking to use derivatives.

I believe that the goal of the Commission in seeking to mitigate the risks of the use of derivatives by Funds would be better served by providing a clear balance between the oversight responsibilities of a Fund's Board and the portfolio management, operational, decision-making process entailed in the use of derivatives that I believe are more appropriately implemented by the Fund's investment adviser. To accomplish that goal, the Proposed Rule should be modified to be more narrowly focused and specifically should be revised by assigning roles to Fund Directors, investment advisers and compliance personnel in a way that more appropriately reflects their functional and statutory roles and responsibilities.

(1) Revising the Proposed Rule. I suggest that the Commission should narrow the final rule on this topic to contain only the following types of provisions, to the effect that:

(a) A Fund may engage in derivatives transactions and financial commitment transactions notwithstanding the requirements of Section 18(a)(1), Section 18(c), Section 18(f)(1) and Section 61 of the 1940 Act, if the Board of Directors of the Fund has approved such investments as part of the Fund's investment policies and strategy;

(b) A Fund's investment policies and strategies with respect to the use of derivatives and financial commitment transactions, and the principal risks attendant to such use, must be appropriately disclosed in the Fund's registration statement;

(c) The investment adviser of a Fund that proposes to engage in derivatives transactions and/or financial commitment transactions (or, in the case of a "self-managed Fund, the appropriate officers of the Fund) must design and implement derivatives risk management policies and procedures and/or financial commitment transaction policies and procedures that are reasonably designed and appropriate for the level of the Fund's investments in such transactions, and shall:

(i) provide the policies and procedures to the Fund's Board for its review prior to implementing such policies and procedures, including provisions with respect to asset segregation for derivatives transactions and/or asset coverage for financial commitment transactions;

(ii) report to the Board at least annually on the implementation of that policy and those procedures;

(iii) provide the Board any proposed material amendment(s) to such policies and procedures prior to their implementation; and

(iv) cause the Fund to maintain in its books and records documentation of such policies and procedures and of all derivatives transactions and financial commitment transactions undertaken by the Fund;

(d) The Chief Compliance Officer of the Fund shall at least annually report to the Board on the design and implementation of such investment policies and procedures pursuant to Rule 38a-1.

(2) Issuance of Formal Commission Guidance. The parameters of the design and operation of a Fund's derivatives risk management program and policies with respect to the use of financial commitment transactions should not be mandated by specific portfolio management requirements and techniques in the final rule, but should be left to the professional judgment of the investment adviser, which would be guided by the Commission's formal guidance containing its views as to the types of factors and limitations investment advisers should consider in designing and implementing such programs, policies and procedures.

Instead of having the final rule mandate specific "required program elements" that incorporate the use of a vaguely defined formulation of VaR, the Commission's guidance to registrants could contain the Commission's views concerning (1) the types of considerations and elements a derivatives risk management program might appropriately include, such as those in Section (a)(3) of the Proposed Rule, (2) the appropriate levels of asset segregation for various types of derivatives transactions and asset coverage for financial commitment transactions, (3) a discussion of the use of various means to measure portfolio exposure to derivatives transactions, including a general discussion of various approaches in utilizing VaR or other appropriate methodologies to do so, (4) the importance of the separation, to the extent practicable, of risk management functions (for the use of derivatives, financial commitment transactions and liquidity risk management) from portfolio management functions, and (5) a discussion of the oversight role of Directors, including a discussion of the application of the business judgment standard that the Commission would look to in evaluating the manner in which the Board has carried out its responsibilities. It would be helpful, as noted, if the guidance also discussed the Commission's views on the application of the provisions of the 1940 Act with respect to concentration and diversification in the case of a Fund's use of derivatives and financial commitment transactions.

I appreciate the opportunity to comment on the Proposal and again recognize and am grateful for the outstanding efforts of the Commission and the Commission Staff, reflected in the scope and breadth of the Proposing Release, in identifying and exploring the appropriate ways to deal with the important issues posed by the use of derivatives and financial commitment transactions by Funds, and for the Commission's focus on how such use affects the soundness of the securities markets, the protection of investors, and the formation of capital.

Respectfully submitted,

Robert G. Zack

Robert G. Zack

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
The Honorable Michael Piwowar

David Grim, Director, Division of Investment Management

EXHIBIT A

The Investment Company Act contains a number of specific functions and requirements of Directors of registered investment companies, including:

- Approve the fund's investment advisory agreement and principal underwriting agreement (§ 15), including interim agreements (Rule 15a-4(b)(2));
- Appoint the fund's custodian and approve the custodian agreement (§ 17(f));
- Approve foreign custody arrangements (Rule 17f-5);
- Approve the use of securities depository arrangements (Rule 17f-4);
- Approve the funds' independent accountants (§ 32(a)(2)) and principal accounting officer (§ 32(b));
- Authorize the fund's method of net asset valuation (Rules 2a-4 and 22c-1);
- For money market funds using amortized cost, adopt procedures (Rule 2a-7);
- Approve any distribution plan and related agreements (Rule 12b-1);
- Approve the Code of Ethics (Rule 17j-1);
- Adopt compliance procedures to prevent and detect violations of federal securities laws and selection of chief compliance officer (Rule 38a-1)
- Approve the issuance of multiple classes of stock (Rule 18f-3);
- Approve the fidelity bond and designate officers to file it (Rule 17g-1(d));
- Approve any joint liability insurance policy with affiliated persons (Rule 17d-1(d)(7));
- Approve affiliated securities transactions (Rule 17a-7);
- Approve procedures for purchases of securities during an underwriting syndicate where an affiliate is principal underwriter of the security (Rule 10f-3);
- Approve procedures for purchasing securities from affiliated broker-dealer (Rule 17e-1)

In addition to the foregoing, investment company directors have the following duties in certain specialized situations or implicitly have such duties by virtue of the requirements that funds adopt or consider adoption of a particular policy or procedures:

- Make certain findings in connection with a merger or consolidation of a fund with an affiliate (Rule 17a-8);
- Determine whether to impose a redemption fee in the case of a fund having daily redemption of shares (Rule 22c-2);
- For hybrid closed-end investment companies that make periodic repurchases of shares, determine the amount of each repurchase and adopt procedures assuring that the fund maintains sufficient liquidity to satisfy its obligations (Rule 23c-3);
- Consider whether an open-end fund should adopt specific policies with respect to market timing (Item 11(e), Form N-1A);
- Consider the adoption of policies with respect to disclosure of portfolio holdings of open-end funds (Item 16(f) of Form N-1A);
- Consider the adoption of policies and procedures the fund uses when voting proxies related to portfolio securities a (Item 17(f) of Form N-1A; Item 18 of Form N-2);
- If fund directs brokerage for portfolio securities transactions to broker-dealers that sell fund shares, approve procedures to prevent certain conflicts of interest (Rule 12b-1(h)