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Industry welcomes final derivatives rule focus on board oversight

Compliance process expected to follow groundwork laid by liquidity rule

Ben Sheng December 7, 2020, 11:29 am

Key Takeaways

- Directors can rely on familiarity of overseeing a board-appointed risk manager
- Seen as major improvement over 2015 proposal
- Fund advisers to face early decisions on portfolio adjustments

The derivatives rule adopted by the **SEC** in October assigns boards appropriate oversight duties while providing a flexible framework for derivatives risk management, according to independent directors and industry observers.

Both the **Mutual Fund Directors Forum** and the **Independent Directors Council** praise the rule for positioning boards to oversee a designated administrator who handles day-to-day risk management responsibilities.

“We applaud the Commission for adopting a comprehensive approach to the use of derivatives by funds that recognizes the board’s important role in oversight, but that doesn’t require the board to engage in activities more appropriate to the fund’s adviser,” MFDF president **Carolyn McPhillips** says in a statement.

“The SEC provided greater flexibility for fund boards to determine the frequency and content of board reports and clarified the fund board’s role in approving the designation of a derivatives risk manager,” says IDC managing director **Thomas Kim**.

Many see the final rule as an improvement over the SEC’s initial 2015 proposal, which drew criticism for containing requirements that some say would have placed directors in the position of having to execute management-like duties.

The rule will require funds with derivatives exposure to establish a standardized risk management program administered by a board-appointed manager. This manager will be required to provide a written report on the program's implementation and effectiveness at least annually to the funds' board.

Funds will also have to set upper limits to their derivatives exposure based on either relative or absolute value-at-risk (VaR) tests depending on the judgment of the program manager.

Funds that hold derivatives as less than 10% of their net assets will be exempt from these requirements but will still have to adopt written policies and procedures designed to manage their derivatives risk.

In addition to adopting the new rule, the commission also amended the ETF rule it passed last year to allow leveraged and inverse ETFs to operate without exemptive orders. The rule had previously prohibited such ETFs from relying on it.

The derivatives rule will go into effect within 60 days of its entry into the Federal Register—which has yet to occur—after which funds will have 18 months to bring their derivatives risk management regimes into compliance.

During the rule's comment period, fund firms pushed back against the specificity of the proposed reporting requirements, arguing that they would require boards to go beyond their proper oversight roles.

Despite these arguments, the SEC opted not to change the reporting requirements in the final rule. Instead it addressed commenters' concerns by affirming that boards should not take on managerial responsibilities.

"The rule did a good job of making sure that the board was involved at the right level, as opposed to getting very technical," says **Rajib Chanda**, partner at **Simpson Thacher**. "The fact that it's the approval and the designation of a derivatives risk manager, and the reports are about the implementation and effectiveness and focus on stress-testing—all of those roles are in the right sort of balance of where the board should be."

Liquidity Rule Déjà Vu

While few boards have met with counsel since the rule was finalized, independent directors who have been tracking the rule since its re-proposal last November say they do not expect their boards to have to adopt unfamiliar or inappropriate duties.

Many observers noted the rule's similarities to the liquidity risk management rule, which advisers and boards spent years preparing between 2016 and 2019. While the derivatives rule does not require directors to approve the risk management program as the liquidity rule did, both rules task directors with designating and overseeing a risk management program administrator who reports to the board periodically.

Directors will likely find themselves working with advisers in much the same way they did two years ago, according to **Perkins Coie** partner **Gwendolyn Williamson**.

"I think it will be a similar process as with the liquidity risk management rule, where you have education and understanding first, and then oversight of development and implementation of the program to ensure that it is best suited to protect the interests of the funds' shareholders," Williamson says.

"My feeling is it's not much different than the liquidity [rule] responsibilities," says **Ira Cohen**, an independent director of the **Angel Oak Funds Trust** and the **Valued Advisers Trust**.

If his funds end up needing to establish derivatives risk management programs, Cohen says he expects his boards and advisers to work in very similar fashion to how they worked when setting up their liquidity risk management programs.

“There was a lot of responsibility put on … the risk officers or the compliance officers to really explain the process, make sure we felt comfortable enough. And then it was to look at the reports, and then revamp the reports and make sure we weren’t overreporting,” he says. “It was a good exercise to really improve the ties and communication between board members and management.”

An independent director of a large fund complex says the rule may introduce more formal procedures but will not significantly change the way by which their board currently oversees derivatives risk.

“We’ve got robust reporting on derivatives risk already,” the director says. “Maybe it makes it a little bit more front and center, where it’s … now something that we’re going to ensure gets minuted and noted for the record.”

Letting the adviser lead

The 18-month compliance window should leave plenty of time for funds to make necessary adaptations, observers say.

The first steps will involve evaluating the rule’s requirements and deciding how they will affect their various fund strategies. Most of this early strategic planning will fall to fund advisers, and directors may have relatively few decisions to make during the first several months of the compliance window, according to Chanda.

“If I were a board, I wouldn’t insist on that being done immediately. I would let the adviser focus on the substance as an initial matter and then come back to the process in due course,” he says.

It will take time for managers to tease out all the rule’s implications for their fund strategies and shareholders. Adjustments to portfolio management strategies may be one facet of adapting to the risk management regime, says **Practus** partner **Ken Earley**.

“A lot of fund complexes are going to have to, in essence, dive in and rethink, how much exposure do they have to derivatives? Do they want to cut it back a little? Do they want to get out of derivatives altogether? If they do maintain derivatives, do they need to comply with the new rule?”

Funds that find themselves hovering around the 10% derivatives exposure threshold may have to decide whether to take their portfolios below that level, so as to avoid extra compliance costs.

“It’s very possible that a fund sponsor may say, ‘Hey, listen, we don’t want to rely on the rule, we’ve got to move this [derivatives exposure level] down,’” Earley says.

To stay plugged in during this phase of the decision-making process, Earley suggests boards either carve out time during board meetings to get updates or schedule regular check-ins with management to discuss the program development.

“It’s a long ramp-up period, but I just think it would be a mistake for boards to wait until the very end, then chime in and say, ‘OK, so what did everyone decide?’”

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