Talking Investment Management: What We Are Hearing in the Boardroom

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Hi there, and thanks for tuning in to the first episode of this Stradley Ronon podcast, hosted by Dave Grim, Mena Larmour, and Christopher Zimmerman. Throughout the episode, you'll learn about new and proposed SEC rules on valuation and derivatives, and what this means to fund boards. For the latest news alerts and podcasts, please visit stradley.com and follow us on LinkedIn and Twitter.

David Grim (00:34):

All right, welcome to this Stradley Ronon podcast. I'm Dave Grimm in the I am Group at Stradley Ronon, and I'm joined by two of my terrific partners, Mena Larmour and Chris Zimmerman. And Mena. Chris and I were just comparing some notes on what we're hearing in the boardroom and what might be valuable for us to share on a podcast to board trustees. And we've come up with some topics that we're hearing a lot about and wanted to share with you what we think you should know about them. So what we're gonna do, if you're like most fund boards, you've been hearing a lot about the valuation rule and the derivatives rule today. Instead of rehashing all that you've heard already, what we wanna give you a sense of is some practical advice on what's coming your way with these rules in the coming months.

David Grim (01:33):

We're gonna spend about 15 minutes or so going through that, giving you some practical tips. It'll be some thoughts on what you should be looking for in your reporting under these rules. Some questions you can consider asking, and some info on what the SEC has been thinking about in some exams. So, with that, let's get cooking on the derivatives rule. You're gonna be receiving a lot of reporting from your derivatives risk manager at some upcoming meetings, and the rule requires a bunch of different things. And Chris, we're gonna start with you and you can just walk through briefly what, what, what's required by the role.

Christopher Zimmerman (02:12):

Yeah, thanks. Thanks, Dave. Hi everyone. So, yeah, we're we're about two months, almost two months into compliance with the new derivatives rule. Now, boards may have seen some of these reports already, but probably not all of 'em or even most of 'em now. First is the regular reporting. The rule requires that for full user funds, the regular reporting be provided to the board at a frequency determined by the board. Now, most of what we've seen so far is a quarterly reporting frequency. However, you know, we have seen some take the approach of providing this report on an annual basis. In any event, I certainly think it can be appropriate, though, for boards to receive the first few reports and see how interesting the information is and how helpful it is in oversight and reassess that frequency as appropriate.

Christopher Zimmerman (03:03):

Now, in terms of the substance of the regular reports, there are a few specific items that are required to be reported. The board should assess whether they find any additional information helpful in their oversight. The reporting should be presented in a fashion that the board, which is not tasked as being a derivatives expert, a VAR or a stress testing expert, can digest in a clear manner. As everyone is aware, boards are responsible for not only derivatives but a host of different things. And so this should be reflected in the materials themselves, so the boards can review and assess the reporting in an efficient manner. Now, in terms of the other reporting, most boards should have already received the annual report from the Derivatives Risk Manager regarding program implementation and effectiveness.

Christopher Zimmerman (03:49):

Unlike two A five, which we'll get into in a minute, this report was required at the outset of compliance with the rule. You know, we have seen multiple different approaches to this report, all of which seemed appropriate, so long as it hits upon the requirements of the rule. As a reminder, you might see a version of this report at the launch of any new fund that is a full user, and you will be seeing it again next year on an annual basis. Now, the final report that you may receive is the ad hoc reports for material events like a var exceedance that is for more than five days. You know, fortunately, we have not seen any of these types of reports yet, but I think it makes sense to have a process set up in place prior to something like that happening. These reports are going to change based upon the nature of the exceedance or other type of material event. But there are certainly procedural elements that can be that are required under the rule, which can be reviewed with the board in advance. Excellent, Chris, thank you for that. Mena. Let's spend a few minutes on what you're seeing in these reports and, in particular, what you think directors should be looking for as they start getting these reports.

Mena Larmour (05:02):

Sure. So, as Chris said, reporting is definitely underway. And we've had the opportunity to see a lot of these reports so far. We've been noticing some trends but some differences. They definitely all address the required elements that Chris spoke about. But how they do so has differed. So we've seen varying levels of detail in these reports. The complexity and granularity of the reporting really depend on the fund complex and the extent to which they use derivatives, the derivatives they use, the purpose, etc., as well as what the board wants. And this all makes complete sense. We've seen a lot of data graphs and charts included, which can be very helpful. You just have to make sure that any necessary explanations accompany them. We've seen some reports that have more summarization than others. The summary format is fine.

Mena Larmour (05:53):

The SEC indicated as much in its release. You just need to make sure that the context and analysis are also provided so that, as a board member, you generally understand what is being conveyed. So, for example, we've seen some reports indicating that there were, you know, a set number of VAR back testing exceptions. What does this mean? What caused the exceptions? Were they statistically significant? How are they being monitored? These are questions that, as a trustee, you'd wanna ask and understand. We all know that sometimes, risk managers may seem to speak a different language. We've seen this language come through in some of the reports that incorporate some complicated risk management concepts. Directors should just really make sure that they're receiving the necessary context and explanation to understand, you know, these concepts that are being conveyed and any significant oversight issues that they should be aware of.

Mena Larmour (06:50):

I just can't reiterate enough that there's anything in the report that you don't understand. The board should ask questions and use this reporting as a means of gaining more knowledge on the topic. I know we've heard it more times recently than I think in the past 20 years that the SEC emphasized that this should be an iterative process. I actually think that the word iterative owes the SEC thanks for increasing its popularity. But it's, it's, it's true. The board's oversight role requires regular engagement. They should ask follow-up questions, and it can evolve over time. Directors are not required to be experts, but you really should have a general understanding of the role and how it applies to the funds that they oversee. Chris, do you wanna add anything on the reporting angle?

Christopher Zimmerman (07:38):

Yeah. So while you know, there are specific requirements under the rule with respect to reporting, you know, there is just an inherent element of flexibility and the actual information that is presented. Boards can certainly provide their input. You know, as Mena mentioned, this is a complicated rule that covers a complicated subject area. You know, the reporting does not need to make things more complicated. In my view, or in our view, <laugh>, the information can be reviewed and enhanced as needed. And I think, again, it's just an iterative process. And you know, what you see now doesn't necessarily need to be what you always see from here on out. I think that's really well said by both of you and would just sort of reinforce those points. There are some very simple questions here, right?

David Grim (08:26):

That is what directors can have on their minds when they're looking at what could potentially be some very complicated reporting. Do you know what the key takeaways are here? What are you trying to tell me with this data? Right? Another sort of simple one to ask to try to flush out what's going on is how you are spending your time. How'd you spend your time the last quarter, you know, as the derivatives risk manager, right? That tends to suss out the kinds of issues that the risk manager's been spending time on. So I think that's great on questions and reporting. Mena, should we kick it to you on the SEC, which is already out on the road, asking some exam questions about this rule very soon after its implementation? Do you wanna, with Chris, I guess, take us through, well, Chris, why don't you start, right?

Christopher Zimmerman (09:19):

And then, Mena, I know you have a perspective to share on that as well. Why don't, why don't you walk us through what's in the exam letter? Yep. So, as Dave just mentioned, the SEC exam letter went out. This exam has been widely reported. It's interesting that the SEC request was for one year, ending on August 30. And with the compliance date of August 19, you know, we're talking about 11 days of compliance. Some of the information requested, like the escalation of material risks, regular reporting, or bar exceedances, simply may not be in existence yet. It's important to note that the board materials piece was just one piece of the exam overall. But I think, you know, requesting what the board has received, it's, it's it's the first place for the SEC to start from, you know, it's, it may be more helpful for 'em to start at that level rather than the detailed worksheets and, and model testing. It's a good place to see overall compliance, you know, in the board materials. So I would imagine the SEC, you know, may not have seen a whole lot of program reports or 38 a one compliance policies and procedures yet. So again, I think this will be interesting to them. That being said, you know, if the SEC finds something deficient, I have no doubt that they will raise it.

Mena Larmour (10:43):

Yeah. Chris, you made a good point that this, this may be in conjecture in the industry, is that this is sort of an information gathering exercise. 'cause The SEC wants to really see what the derivatives programs look like for these fund groups and the board materials that are being provided. 'cause They don't have access to that. And the rule wasn't prescriptive in that regard. So, not that I'm trying to plug law firms here, but this is an area where boards can use their outside counsel who do have access to all of this reporting from a variety of fund groups and can provide comments if the reporting seems to be an outlier. So, I think a, as a board member, I would be asking, you know, are, are these what you're seeing? Is this generally what you're seeing in the industry of my outside counsel?

Christopher Zimmerman (11:30):

Well done. Anything else that you guys wanna share on derivatives before we shift evaluation? No. All right. Let's go to the valuation. Let's, let's turn to valuation, and we're gonna fly through this one a little more quickly because I think, you know, boards historically have been very involved in valuation issues. And so while the new rule makes some changes to how that's gonna roll, I think boards have a familiarity with these issues that will allow us to move through this pretty quickly. And one thing I would point out before we get to the valuation reporting, which is gonna be the main way that you engage with this rule going forward, I'd just like to point out that the rule allows for boards to designate to their advisor the responsibility for fair valuation. And that is really important to boards, right?

Christopher Zimmerman (12:21):

I think historically that's kind of the way it should have been, but it was a little unclear whether the law actually allowed that; this rule does allow that. I think that clarity of roles is a good thing for boards and for management, actually going forward. So in that scheme of being permitted to designate responsibility to the advisor, of course, that makes it important for the board to get good reporting from the advisor on what the advisor's up to. Right? So, the rule requirements for evaluation reporting are somewhat similar to what we just went through with derivatives. There are three main kinds of reporting, right? There's the regular quarterly reporting on some certain specific topics. There's an annual assessment of how it's going. And there is certain, there are certain items that have to be promptly reported to the board, which can be sort of outside of the regular calendar of, of board meetings. So that's broadly what the regulatory scheme is. Mena, do you wanna spend a few minutes talking about what you are seeing in the boardroom and in light of those requirements?

Mena Larmour (13:34):

Sure. So, the big influence on the substance of this new report is the existing reporting. What boards are used to seeing this has typically been the starting point for a two-to-five implementation. A number of fund groups and boards are kind of using two to five as a catalyst to take a fresh look at valuation reporting, which is a good thing. Based on that starting point, you know, what you've historically seen or been providing, some groups are adding more reporting, some are taking reporting away. We've seen summarized dashboard reporting as a trend, and the level of detail supporting that dashboard reporting has varied. We've seen some boards moving away from reports and individual fair value securities, and instead focusing on trends that can help them get comfortable with the valuation designees' valuation process overall. For example, looking at quarter over quarter significant changes in fair value rather than a report on every fair value security.

Mena Larmour (14:39):

The valuation risk assessments that are, you know, discussed in the role also vary among fund groups. First of all, they vary as to whether the initial valuation risk assessment is even provided. The role doesn't require that an initial risk assessment be provided. But we have seen a number of fund groups providing one to the boards just to give them context as to the periodic reporting requirement to report on any material changes to the assessment evaluation risks. So it kind of gives you that, you know, starting point. For these fund groups that have been providing this risk assessment, we've seen them vary as to the level of detail and granularity. Some have just been focused on the specific factors that the adopting release identified that needed to be included. Some have been kind of adding additional factors that maybe they had historically used more informally, and kind of making that a more formal tracking of risk.

Mena Larmour (15:40):

We've seen a lot of these risk assessments using risk ratings, heat maps, numerical scoring some of, some of this has been modeled after reporting that auditors use. I think the key to the valuation risk assessment is just to make sure that there's also an aspect of how those risks are mitigated and monitored. So I would be looking for that as a trustee. I guess overall, the periodic reporting element that Dave discussed has a catch-all provision that requires the advisor to provide anything requested by the board. So that has resulted in, you know, different reporting depending on the different boards, which is okay, you know, how, however, the board feels it, whatever it feels it needs to perform its oversight function. Dave, did you have anything you wanted to add on reporting? Do you know any questions? What should the board be looking for?

David Grim (16:35):

Yeah, I think that's great, Mena, and like, sort of as you think about reporting and the kinds of questions you might think about asking as a trustee, I think some of the questions are similar to what we talked about with derivatives, right? Like, what is the key takeaway from all this information you're giving me? Like, why are you telling me this? Or what, how have you been spending your valuation time in the last quarter? You know, are there particular risks you've been focused on or particular types of securities you've been focused on, that kind of, that kind of thing? In terms of some other, more specific things, I think pricing service oversight and due diligence are a big piece of the new rule. And again, delegation creates an opportunity for boards to formally turn that over to management, right?

David Grim (17:24):

So, to the extent boards have been having visits from pricing service pre per pricing services previously, I think you can think about whether that is still necessary. You can do it if you want to, but you don't necessarily have to, right? You can rely on the advisor to do that. The last area of sorts of questions that I would consider if I were a trustee is around the testing, right? Like, all right, you're assigning these fair values. Are you comparing those to actual transactions in the market? And how's that comparison going? You know, does it line up and justify how you’re valuing? So there are some questions to think about. So, as a way of bringing this to a close, Chris, I think we wanted to hit on a couple of issues that we view as sort of common to both the derivatives rule and the valuation rule.

Christopher Zimmerman (18:14):

Do you wanna highlight those for us, please? Sure, one thing, and we’ve talked about this already, but it’s just reliance on experts. You know, I think valuation may, to a certain extent, come more naturally because this was already an existing process, but in both rules, the derivatives risk manager and the advisor are subject matter experts on both derivatives and valuation. The boards can rely on these entities and other experts to provide the appropriate oversight. That being said, just generally, boards are expected to have a level of understanding in order to provide that oversight. The other thing would be that while boards can, you know, expect plenty of reporting here in general, they should expect that they will not be asked to take action under these rules very often.

Christopher Zimmerman (19:07):

For example, only very significant items under the derivatives rule will require immediate action in terms of receiving reports. As Mena said, ask questions, be diligent and oversight and demonstrate, and demonstrate that oversight with respect to both rules. And finally, I would say as a general reminder, I think your board minutes and the record generally should reflect the level of oversight that the board is undertaking. This type of over type of oversight can be demonstrated as something that has always been important, but now, especially, I think more so now that the board is tasked with the specific oversight of derivatives, risk management and valuation under these rules. Great stuff, Chris. And Mena as well. Thank you both. But, you know you’re terrific on this stuff and, and, and fantastic colleagues to boot. I appreciate you hanging out with me today and, and sharing your insights. Thanks to all of our listeners for joining us today. If you like what you heard, Lena, please join us for the other part of our series. That podcast is gonna be about some new rules, some new rules from the SEC that are coming down the pike, in particular ESG, cybersecurity and the names rule and what fund directors need to know about those. So that’s a wrap for us today. Thanks again for listening. Have a good day. Bye-Bye.

(20:25):

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