INVESTMENTS IN DERIVATIVES BY REGISTERED INVESTMENT COMPANIES

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INVESTMENTS IN DERIVATIVES BY REGISTERED INVESTMENT COMPANIES

I. INTRODUCTION AND PURPOSE

Investments in derivative instruments by mutual funds and other registered investment companies recently have come under increased scrutiny. Last winter, the Securities and Exchange Commission's Division of Investment Management formed a study group to review mutual funds' use of derivatives and related issues[1]. The SEC's inspection staff has been directed to pay particular attention to funds' investments in derivatives and management controls over such investments[2]. On June 15th, Chairman Edward J. Markey and Congressman Jack Fields of the House Telecommunications and Finance Subcommittee issued a request that the SEC undertake a comprehensive study of the use of derivatives by mutual funds[3]. SEC Chairman Arthur Levitt subsequently sent letters to fund groups[4] and to the Institute[5] expressing concerns about mutual fund investments in derivatives and urging greater attention by fund management and directors to such investments and related issues.

Moreover, in response to an earlier request by several members of Congress, on May 18th, the General Accounting Office ("GAO") released a report on financial derivatives.[6] Shortly after the GAO report was published, SEC Chairman Levitt testified at Congressional hearings on financial derivative instruments generally and the GAO report in particular. In his testimony, Chairman Levitt stressed, among other things, the importance of the role of investment company directors with respect to derivatives, noting that "[w]hile the Commission's resources are sufficient to permit it to scrutinize the derivatives activities of mutual funds on only a periodic basis, the directors of each fund are positioned and obligated to promote the interests of the fund's shareholders on an ongoing basis."[7] Chairman Levitt has stated that "the evolving nature [of derivatives] makes them an important subject of director inquiry."[8]

The GAO report also found, among other things, that "[b]oards of directors, senior managers, audit committees, and external auditors all have important roles in ensuring that derivatives risks are managed effectively.[9] The GAO report suggested that strong internal control systems and independent, knowledgeable audit committees "are critical to firms engaged in complex derivatives activities and should play an important role in ensuring sound financial operations and protecting shareholder interests of these firms."[10]

In light of these important developments, the Institute has prepared this memorandum in order to -- (1) provide information to members of fund boards of

directors and senior management of investment advisers to funds concerning derivative instruments; (2) discuss certain regulatory and other issues that may arise in connection with fund investments in such instruments; and (3) identify some possible areas for inquiry and consideration by directors and investment advisers.

It is important to note that, despite recent interest in the use of derivatives (both by mutual funds and others), there is nothing inherently troublesome about fund investments in derivatives. Indeed, investments in derivative instruments can, in many instances, better enable a fund to achieve its investment objectives.

In addition, it should be noted that industry practice, both with respect to disclosure matters and other issues discussed herein, has evolved as investments by funds in derivative instruments have risen. It is likely that practices will continue to evolve as the market develops further. Accordingly, this memorandum is not intended to present any views as to what may have been appropriate matters for consideration by fund boards or investment advisers in the past, nor what necessarily will be appropriate matters for such consideration in the future. Moreover, the discussion herein is, of necessity, general in nature; particular circumstances will vary and may dictate different conclusions or applications of the law.

The remainder of this memorandum is structured to reflect important differences in the roles of fund directors, on the one hand, and investment advisers, on the other, with respect to fund investments. Section II sets forth certain background information on derivatives. Section III outlines general oversight responsibilities of fund directors concerning investments in derivatives. Section IV (comprising the bulk of the memorandum) identifies separate issues and considerations for investment advisers to funds. As with other investment activities, it is the responsibility of the investment adviser to manage, on a day-to-day basis, investments in derivative instruments. Nevertheless, fund directors may find such a discussion to be informative and useful in connection with their own oversight responsibilities.

II. BACKGROUND

A. Definition of Derivatives

The term "derivatives" has been used to identify a range and variety of financial instruments. There is no discrete class of instruments that is covered by the term, and the term often appears to be used to describe every financial instrument that is not a traditional stock or bond. A "derivative" commonly is defined as a financial instrument whose performance is derived, at least in part, from the performance of an underlying asset (such as a security or an index of securities). These financial instruments include, for example, futures, options on securities, options on futures, forward contracts, swap agreements, and structured notes. In addition, participations in pools of mortgages or other assets often are described as "derivatives." Brief descriptions of these instruments are set forth in the Appendix to this memorandum.

It is sometimes relevant to distinguish between *derivative instruments that are traded on an exchange* or through another organized market (such as futures and options on futures), and *"OTC derivative instruments"* (such as currency forward contracts or swap agreements). Some OTC derivatives, such as structured notes, are agreements that are individually negotiated between the parties, and thus can be tailored to meet the purchaser's specific needs. Unlike exchange-traded derivatives transactions, OTC derivatives transactions are not guaranteed by a clearing agency. As a result and as discussed below, there are certain credit risks that are particularly applicable to OTC derivatives.

B. Investments in Derivatives

A fund may invest in derivatives for a variety of reasons, including for "hedging" (i.e., risk reduction) purposes;[11] and as a substitute for investment in "traditional" securities.[12] It is misleading, however, to suggest that all derivatives investments can be classified as either "hedging" or "speculation." No such simple or stark dichotomy is possible.

Fundamentally, the evaluation of a potential investment in a derivative instrument is no different from the evaluation of potential investments in traditional debt and equity securities. Generally, a portfolio manager's decision to invest in a particular security or derivative instrument on behalf of a fund will reflect that manager's judgment that the investment will provide value to the fund and its shareholders and is consistent with the fund's objectives and policies. In making such a judgment, the benefits and risks of the investment should be analyzed and weighed in the context of the fund's entire portfolio and objectives.

Like the fund's other investments, a fund's derivative investments may entail various types and degrees of risk, depending upon the characteristics of the particular derivative instruments and the fund's portfolio as a whole. Derivatives often permit a fund to increase, decrease or change the level or types of risk to which its portfolio is exposed in much the same way as the fund can increase, decrease or change the risk of its portfolio by making investments in more or less risky types of securities. For example, an investment company could increase the market risk associated with its portfolio by investing in debt securities with longer maturities, or could achieve a similar result by investing in a derivative instrument that has the same stated maturity but a longer duration (such as an inverse floating rate bond).

In some instances, derivative instruments may provide a cheaper, quicker or more specifically focused way for an investment company to invest than "traditional" securities would. An investment company also may be able to obtain exposure not available through an investment in traditional securities by purchasing a derivative instrument (e.g., by buying a note linked to rates in a foreign market in which few issuers meet the fund's credit quality standards).

C. Money Market Funds

Investments in derivatives by money market mutual funds recently have received special attention. In a letter dated June 17th to the Institute, SEC Chairman Levitt stated that, "money market mutual fund managers, in particular, must take a close look at their use of derivatives and other financially engineered instruments."[13]

Money market funds raise unique issues, in light of their stated objective of maintaining constant net asset values. Rule 2a-7 under the Investment Company Act of 1940 imposes very strict standards on the portfolios of money market funds, including detailed limitations designed to minimize both credit risk and market risk. Securities that do not meet these standards, whether or not they could be characterized as "derivatives," are not appropriate investments for money market funds. Thus, for example, the SEC staff has stated that structured notes such as inverse floaters, which have increased exposure to interest rates, are ineligible investments for money market funds.[14] At the same time, however, the fact that an instrument might be considered a derivative does not mean that it is *per se* an inappropriate investment for a money market fund. Tax-exempt money market funds, for example, hold substantial amounts of variable rate demand notes and similar instruments that could be considered to be derivatives. These instruments are designed specifically to comply with the requirements under Rule 2a-7 that money market funds hold only high-quality short-term securities.

III. DIRECTORS' RESPONSIBILITIES WITH RESPECT TO DERIVATIVES

As with other fund investments, it is the directors' responsibility to review and approve policies developed by the investment adviser and other service providers with respect to derivatives, and to oversee those entities' performance of their duties. As SEC Chairman Levitt has stated, directors are not required to "micromanage the minutiae of individual derivatives transactions," but are obliged to "exercise knowledgeable and meaningful oversight."[15]

All fund investments, to varying degrees, involve market and credit risks, as well as the risk of volatility or illiquidity if market conditions change. Derivatives, however, have features that may deserve special attention from fund directors. Many derivatives entail investment exposures that are greater than their cost would suggest, meaning that a small investment in derivatives may have a large impact on a fund's performance. Many types of derivatives are novel, some are highly complex, and some involve concepts that have not been fully tested by market events. Importantly, the investment exposures conveyed by derivatives often are obscure to the non-specialist, and may not be captured by traditional monitoring procedures designed for stocks and bonds. The unfamiliarity of derivatives, including their capacity to surprise professionals as well as investors by their performance, has probably done more to give them a reputation for risk than any other factor.

To address these characteristics of derivatives, fund boards may need to review existing practices of the fund and its adviser to determine whether derivatives are appropriately addressed in the areas of investment oversight, compliance and operational monitoring, and disclosure to investors. In some cases, current policies may need to be revised or refined to incorporate the impact of derivatives properly, while in others new policies or controls may be needed. At the same time, derivatives should be analyzed in the context of a fund's entire portfolio, and should not be allowed to overshadow more significant risks that funds may be taking in conventional securities markets.

There are, of course, a variety of specific means by which directors appropriately might go about fulfilling their oversight responsibility with respect to derivatives. These means will depend upon the context and the particular circumstances of the fund, including the level, types and objectives of a fund's derivatives investments. In general, these means might include:

- Understanding generally the types ofderivative instruments in which the fund may invest, the objectives of such investments and the nature of risks associated with such investments.

- Requesting, receiving on a timely basis and reviewing information from the investment adviser about the adviser's overall strategy with respect to investments in derivatives. Such information might include, for example, discussions with portfolio management personnel about any proposals to change significantly the fund's use of derivatives, and periodic reports to the board on the extent to which a fund is using derivatives, how they are consistent with the fund's investment policies, and their effects on the fund's performance.

- Reviewing the fund's pricing procedures for securities for which market prices are not readily available to determine whether or not such procedures are appropriate for derivatives in which the fund may invest; and reviewing pricing issues relating to specific types of derivatives, to the extent such issues requiring the board's attention may arise.

- In the context of ongoing supervision of the fund's prospectus disclosure in general, considering the adequacy of such disclosure in light of the fund's derivatives investments, and consulting with fund management regarding other shareholder communications, in order to ascertain whether the parties responsible for preparing such communications have sufficient understanding of the fund's derivative strategies to reflect the impact of derivatives appropriately.

- Obtaining assurances from the adviser as to the derivatives expertise of its portfolio managers and analysts, its operational capacities, including compliance, regulatory, accounting and tax resources, its trading and documentation practices, and its internal controls. The board also should be fully informed by the adviser as to how risk management responsibilities are allocated within the adviser's organization, and understand the risk management principles the adviser applies.

IV. INVESTMENT ADVISER'S RESPONSIBILITIES WITH RESPECT TO DERIVATIVES

A. General

As with the responsibilities of the directors, the typical responsibilities of the investment adviser with respect to a fund's investments in derivatives are no different from its responsibilities with respect to other fund investments. Generally, these responsibilities of the investment adviser are to manage, on a day-to-day basis, the fund's investments in derivatives, subject to the fund's investment objectives, policies and limitations, and to report to the board, in a timely manner, significant information concerning the fund's investments in derivatives. The specific responsibilities of the investment adviser with respect to derivatives, like those of fund directors, will vary depending upon the context and the particular circumstances of the fund, including the level, types and objectives of a fund's derivatives investments.

Among the issues that senior management of an investment adviser may wish to consider are the following:

- The derivatives expertise of portfolio managers and analysts. This includes, among other things, their ability to determine whether a particular derivative instrument is fairly priced and what factors will affect its return under various market conditions.

- The goals of the fund's proposed use of derivative instruments, and how the success or failure of the use of derivatives will be evaluated. For example, derivatives positions intended to reduce risk might lose money but still represent a successful strategy.

- Whether personnel in various areas of the organization (e.g., legal, compliance, accounting and marketing) understand the derivatives in which the fund will invest, or whether it may be helpful to set up training sessions.

- What controls will be put on new derivatives investments, and how compliance with those controls will be implemented and monitored. For example, it may be necessary to implement procedures requiring a

portfolio manager to communicate with legal, compliance, tax and accounting staff before investing, to ensure that the investment is consistent with legal and other restrictions and that it will be accounted for and valued properly.

B. Disclosure Requirements and Related Issues

A fund's policies and practices with respect to derivative instruments are subject to a number of disclosure and other requirements under the federal securities laws. Generally speaking, the fund's registration statement must provide disclosure about all significant fund investment practices and risks, including those relating to investments (or potential investments) in derivatives. In addition, those investments must be consistent with the fund's stated investment objectives and policies, with its name, and with its risk profile as set forth in the fund's prospectus, sales materials or other disclosure documents. Put another way, the fund's investments in derivatives should be consistent with the reasonable expectations of the fund's investors.

1. Prospectus Disclosure Concerning Derivatives

A fund that is engaging, or that may engage, in derivatives transactions must include disclosure concerning those investments in its registration statement,[16] just as it must describe other significant investment policies or practices. In February 1994, the staff of the Division of Investment Management noted that fund disclosures regarding derivative instruments often are "lengthy and highly technical in nature." Thus, the staff has "strongly encourage[d] registrants to review their existing disclosure concerning derivative instruments to identify areas of such disclosure that can be deleted, reduced or modified to enhance investor understanding about pertinent risks."[17]

In context of such a review, it may be useful to consider whether prospectus disclosure concerning fund investments in derivatives is (as it should be) presented in relation to the rest of the portfolio. For example, prospectus disclosure regarding the contribution of derivatives to the overall risks of a fund is more relevant and meaningful than disclosure of the risks of individual derivative instruments.

2. Consistency of Investment Practices with Disclosure

Prospectus disclosure should be reviewed regularly so that it remains accurate in light of the fund's actual practices or intentions. Equally important is the need to monitor the fund's investment practices involving derivatives in order to determine whether they are consistent with other disclosures made by the fund, including disclosures regarding the fund's investment objectives and its risk level, the fund's name, and disclosures in fund advertisements and sales literature.

a. Investment Objectives and Policies

A fund's investments in derivatives must be consistent with its investment objectives and policies as described in the fund's registration statement.[18] For example, a fund with stated investment objectives that evidence a conservative investment approach ordinarily would be expected to refrain from investing its assets in highly volatile instruments in a manner that materially increases its overall risk.

On the other hand, it may be appropriate for such a fund to engage in derivatives transactions, even if highly volatile, that are intended to reduce risk.

In addition, a fund's derivatives investments must be consistent with its stated investment policies[19] including, for example, those governing the issuance of senior securities, investments in restricted or illiquid securities, borrowing or lending money, margin purchases, engaging in short sales, industry concentration, and investing in real estate and commodities.

b. Name

A fund's investments in derivatives should not be inconsistent with its name.[20] Thus, for example, the ABC Bond Fund ordinarily would not be expected to invest in stock index futures, or in a bond whose total return depends on stock market performance, unless investors in the fund have been clearly informed that the fund will take on stock market risk.[21] Of course, analyzing the appropriateness of an investment in a particular type of derivative instrument may not always be so straightforward. For example, more complex derivative instruments, such as those that combine different types of risks (e.g., a bond issued by FNMA with coupon payments linked to foreign currencies) may present difficult issues in this regard, depending upon the specific nature and policies of the fund in question.

The capacity to analyze and handle these types of issues, where and when they arise, should be built into a fund's compliance procedures.

c. Advertising and Sales Literature

The nature and extent of a fund's investments in derivatives also may need to be considered in connection with the drafting of fund advertisements and sales literature. This issue was highlighted earlier this year in a civil proceeding by the New York Attorney General against a municipal bond mutual fund. In April, the fund settled charges by the Attorney General that it engaged in deceptive advertising and sales practices because its sales literature stressed the fund's conservative nature but failed to disclose the risks inherent in investing in the fund. (At the time in question, forty percent of the fund's assets were invested in derivatives -- specifically, inverse floating

rate municipal bonds.) Significantly, the fund's derivatives investments apparently did not adversely impact its performance during the period investigated by the New York Attorney General.

According to press reports at the time of the settlement, as a result of this case, the New York Attorney General planned to undertake investigation of "other funds' disclosure of risks due to fixed-income derivatives, especially so-called inverse floaters."[22] Thus, in a July 18th letter to Congressman Edward Markey, the New York Attorney General indicated that his office had identified eight mortgage income funds that experienced declines in their share prices of more than twenty percent in the first six months of 1994 due to investments in "exotic mortgage derivatives - primarily inverse floaters, principal-only strips and inverse interest-only strips."[23] The letter expressed concerns about, among other things, disclosures in the sales materials for five of the funds. It further stated that the Attorney General is "investigating the extent to which false and misleading information in such sales materials may have been transmitted to the public by salespersons."[24]

Although fund sales materials need not discuss specific portfolio investments -- derivative or otherwise -- the investment adviser should have in place appropriate lines of communication and procedures for reviewing disclosure in fund sales materials. Such disclosure should reflect accurately the risks involved in investing in the fund, including as these may be affected by the fund's investments in derivatives.

3. Other Disclosure Concerning Derivatives

a. Periodic Reports to Shareholders

Mutual funds other than money market funds are required to provide, either in their annual report to shareholders or their prospectus, a periodic discussion by management of the fund's performance (sometimes referred to as the Management's Discussion and Analysis or "MD&A").[25] Specifically, the MD&A must "discuss those factors, including the relevant market conditions and the investment strategies and techniques pursued by the [fund's] investment adviser, that materially affected the performance of the [fund] during the most recently completed fiscal year."[26]

Thus, funds that follow investment strategies or use techniques involving derivatives to an extent that materially affects performance should include appropriate disclosure in the MD&A. In this regard, the staff has suggested informally that MD&A disclosure concerning derivatives should include, for example, discussions of how derivatives were used during the period and the portfolio manager's market view.[27]

b. Financial Statement Disclosure

All instruments held by a fund must be identified in the fund's schedule of investments.[28] As in the case of conventional securities, the disclosure for derivative

instruments should include the name of the issuer and title of the issue, the principal amount or number of units held, and the current market value of the investment.[29] Frequently, derivatives include special terms or conditions that alter the risk-return characteristics of the instrument. These terms or conditions, if material, also should be included in the description of the instrument.

For example, a fund may own a structured note where the principal due at maturity is inversely indexed to an unrelated indicator (e.g., the principal amount due at maturity decreases as the price of gold increases). In this example, the issuer, interest rate, maturity date, market value and original principal amount should be disclosed. The relationship between the principal amount due at maturity and the price of gold should be clear.

Federal securities laws and generally accepted accounting principles also require certain disclosures regarding derivative instruments to be made in the footnotes to a fund's financial statements. These required disclosures include a schedule detailing any option writing by the fund and disclosure of the amount, nature and terms of instruments with off-balance sheet risk of loss.[30] Funds may wish to consider placing derivative disclosure in footnotes near disclosure for comparable derivatives in portfolio listings to facilitate understanding of the fund's overall position.

In response to widespread concerns about the inadequacy of current financial statement disclosure about derivatives (mostly focusing on entities other than investment companies), the Financial Accounting Standards Board recently issued a proposed Statement of Financial Accounting Standards ("SFAS") entitled "Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments." As proposed, this SFAS would apply to all entities that prepare financial statements in accordance with generally accepted accounting principles, including registered investment companies. The proposed SFAS would require, at a minimum (1) a description of a fund's objectives for holding derivative instruments and the strategies for achieving those objectives, and (2) a description of how the derivative instruments are reported in the financial statements.

4. Evaluation of the Adequacy of Disclosure - Risk Considerations

In evaluating the adequacy of prospectus and other disclosures, including whether particular derivatives investments are consistent with existing disclosures, a key consideration is the nature and level of risks that such investments may entail. This is the case, of course, with respect to all of a fund's investments, not just investments in derivative instruments.

The risks presented by a fund's derivatives investments may include (1) **market risk** -- i.e., the risk that the market value of the derivative instrument will decrease, as a result of changes in interest rates or other market conditions; and (2) **credit risk** -- i.e., the risk that the counterparty to a derivatives transaction will default on its obligations,

or that legal impediments will interfere with the counterparty's ability to perform its obligations. These risks are discussed below. It should be noted that these are the same types of risks that must be assessed in connection with a fund's investments in "traditional" securities, although in the case of some derivative instruments, these risks may be harder to measure. Investments in derivatives also may involve certain operational risks, some of which are outlined in Section IV.D. of this memorandum.

a. Market Risks

i. General

Derivatives, like other investments, involve certain market risks. Different types of derivatives present different market risks, and even the same derivative instrument may have different effects upon a fund's overall risk, depending on its use and the nature of the fund's portfolio. For example, a fund that invests in Japanese stocks might utilize forward contracts on the yen to seek to reduce the total risk of the portfolio. On the other hand, those same forward contracts might increase the risk of a fund that had relatively little exposure to Japanese stocks. Accordingly, as noted above, it is important to understand the purpose of a derivative instrument in the context of the entire portfolio, and the effect of that derivative instrument on the risk of the entire portfolio.

ii. Certain Market Risk Considerations

The fund's investment adviser should have adequate procedures in place to evaluate the market risks of investments in derivatives. Given the constantly increasing variety of derivatives, as well as the different ways in which they may be used, it is not feasible to list all such risk considerations. Some market-related risk considerations, however, include:

- How can derivative instruments be expected to perform under various market conditions (including a "worst case scenario"), and how will this impact the fund's portfolio? Consideration also should be given to whether the performance changes substantially in certain market conditions, and how that would affect the rest of the portfolio. With respect to certain derivative instruments such as structured notes, it may be useful for the investment adviser to evaluate the instruments' sensitivity to specific market indicators (such as a one percent interest rate change or stock market move, depending upon the instrument).

- How reliable in predicting risks is simulation and modeling? A portfolio manager's analysis of a derivative instrument's expected behavior may be based upon a computer simulation or other model. This may be useful in connection with assessing the potential impact of derivatives on a fund's portfolio in unusual or stressful market conditions. Nonetheless,

consideration should be given to the possibility that actual experience will vary from expectations due to limitations in the model's design.

- How sound is the fund's hedging strategy? If derivatives will be used to hedge securities positions held by the fund, there is the risk that the strategy will be unsuccessful, for example, because of market inefficiencies or because of a lack of correlation between changes in the values of the derivatives and securities positions. Another consideration related to hedging strategies is the possible need for the investment adviser to implement procedures to assure that derivatives positions will be "unwound" at the time a fund sells the securities position it is hedging. Investment advisers implementing a hedging strategy should clearly understand the limitations of the hedge and the factors that may cause it to fail.

- What types of risk exposure does a derivative instrument add to the portfolio? For example, if a fund's portfolio is significantly invested in short-term debt securities, and it invests in derivative instruments that have the effect of increasing its exposure to interest rate risk (such as purchased futures contracts on 30-year Treasuries), the risk exposure of that portfolio may significantly increase. Another concern in this regard is that use of derivatives may alter a fund's portfolio composition. For example, assume that a fund, which intends to maintain a roughly 50% exposure to equity and 50% exposure to debt, purchases futures contracts on the S&P 500. A relatively small investment in the futures contract can allow the fund to control a substantial block of stock, and may result in the fund effectively becoming over-invested in equity.

- What is the liquidity of the derivative instrument? As with other investments, in a time of market stress when heavy redemptions might make it desirable to dispose of a derivative instrument to raise cash, liquidity may decrease or evaporate. As a result, the instrument could increase the fund's volatility. This concern may be greater in the case of more specialized derivatives, or derivatives linked to relatively illiquid markets.

- Do any special limitations apply to the fund's portfolio? For example, the restrictions applicable to investments by money market funds are described more fully above.

Recent, highly publicized industry experience -- including short-term government bond mutual funds, the value of whose derivatives investments declined significantly -- underscores the importance of carefully analyzing and monitoring the market, liquidity and other risks of such investments. It also illustrates the need, discussed above, to consider the suitability of particular investments for particular

funds and the adequacy of information provided to investors concerning the risks of such funds.

b. Credit Risks

i. The Risk of Counterparty Default

OTC derivative instruments in particular present a risk that the other party to the transaction (i.e., the "counterparty") will default on its obligations with respect to the derivative instrument. In general, this risk is less significant in the case of transactions involving futures, options on futures, options on securities and other derivative instruments that are traded on an exchange. This is because transactions in exchange-traded derivatives generally are guaranteed by a clearing agency that imposes a system of margins designed to reduce credit risks. Clearing agencies are particularly significant risk-reducing mechanisms; in effect, the counterparty to every transaction on an exchange is the relevant clearing agency. As a result, unless the clearing agency defaults, there is relatively little credit risk associated with a derivatives transaction entered into on an exchange.

By contrast, no clearing agency guarantees transactions in OTCderivatives. Therefore, each party to an OTC derivatives transaction bears the risk that the counterparty will default. Accordingly, fund advisers should consider the creditworthiness of OTC derivative counterparties in the same manner as they would review the credit quality of a security to be purchased by the fund. In this regard, it may be useful for the investment adviser to maintain a list of approved counterparties that meet certain creditworthiness criteria.

Another consideration is the fund's exposure to a particular counterparty. It is worth noting that a relatively small number of banks, brokerage houses and other financial institutions currently dominate the OTC derivatives markets. Thus, a fund may find that its OTC derivatives transactions involve a relatively small number of counterparties, either as a result of the limited number of choices or as a result of its familiarity with a particular counterparty. The greater a fund's exposure to a particular counterparty, the greater the potential adverse impact on the fund if that counterparty defaults on its OTC derivatives obligations. This was a serious concern to many investors during the final days of Drexel Burnham Lambert, which was a counterparty to a number of OTC derivatives transactions. As discussed below, however, both the federal securities laws and the federal tax laws may limit a fund's exposure to a single counterparty.

ii. Legal Risks

Investments in derivatives also may give rise to various legal risks. A prominent example of one type of legal risk associated with OTC derivatives transactions involved

the London Borough of Hammersmith and Fulham, which in 1991 defaulted on five years' worth of sterling interest rate swaps to which it was a party, following a ruling by the House of Lords that it lacked the authority to enter into the swap agreements.[31]

Accordingly, fund advisers should have procedures in place to assess the legal risk of derivative instruments. In some cases, fund advisers may need specialized legal assistance to review derivative instruments, particularly with respect to issues relating to the Commodity Exchange Act, domestic and foreign tax law and state laws, which may be less familiar to such advisers than the requirements of the Investment Company Act of 1940.

In addition, reviewing documentation for certain OTC derivatives may require specialized skills. In this regard, it is important to assure that the terms of a proposed transaction are appropriate in light of the portfolio manager's intended goals. In some cases, such as with swap agreements, the documentation has become fairly standardized. In other cases, particularly in transactions involving relatively new OTC derivatives, the documentation is less standardized. Thus, where necessary, the investment adviser should enlist appropriate personnel (i.e., in-house or outside counsel) to review and approve OTC derivative documentation before the fund enters into a transaction.

C. Other Regulatory Issues

1. General

In addition to the disclosure and other issues discussed in the previous section, various provisions of the federal securities laws, state securities laws, federal tax laws and federal commodity laws may apply to a fund's investments in derivatives. Senior management of the investment adviser may find familiarity with these requirements useful in connection with taking steps to assure compliance with them and any related fund policies. Some of the more significant regulatory requirements and related issues are summarized below.

2. Federal Securities Law Issues

a. Senior Securities

The Investment Company Act of 1940 generally prohibits mutual funds from issuing or selling "senior securities".[32] The Commission and its staff take the position that a fund's investments in certain derivative instruments may involve the creation of senior securities, because the fund could end up owing more money in the future than the amount of its initial investment. For example, a fund may purchase futures contracts by making a relatively small margin payment.

The Commission and the staff have established certain asset segregation or "cover" procedures that a fund may follow to avoid the potential creation of a senior security.[33] Essentially, the fund either must hold an offsetting position, or must set aside in a segregated custodial account liquid, high grade debt securities in an amount sufficient to cover its potential future obligation.[34] These requirements are intended to ensure that the fund will be able to meet its future obligations, and they also function as a practical limit on the amount of leverage the fund may undertake.[35]

Among the issues that may arise in this area are questions about the amount that should be segregated with respect to positions in certain types of derivatives. For example, in the case of swaps, there are no formal SEC or staff pronouncements on coverage requirements.

It should be noted that while asset segregation and other "cover" requirements effectively control the maximum risk of loss on derivatives transactions that have true leverage potential (i.e., the possibility of losses in excess of the fund's investment), they do not address all risks of derivative investments. For example, the same amount of coverage is required for a futures contract on U.S. Treasury bills as for a futures contract on the Nikkei index, even though they involve different levels of risk. In addition, asset segregation is not required for certain derivative instruments such as structured notes, because the fund's risk of loss is limited to the amount invested and, thus, the leverage concern that the 1940 Act addresses is not raised. These instruments, however, are sometimes referred to as "leveraged," based on their degree of sensitivity to changes in interest rates, or in the value of some underlying asset, as a result of which they may be relatively volatile investments.

These requirements and risk considerations should be taken into account in connection with the development of a risk management policy for a fund that invests in derivatives.

b. <u>Liquidity</u>

A mutual fund may not invest more than fifteen percent of its net assets in "illiquid assets."[36] The SEC staff defines an illiquid asset as any asset that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment.[37] Ordinarily, exchange-traded derivatives -- such as certain options on securities, and futures and options on futures -- have readily available markets, and therefore would not be subject to the fifteen percent limitation.[38] Many OTC derivatives -- currency forward contracts, for example -- also have deep and liquid markets. In the case of some OTC derivatives, however, and in the case of derivatives linked to illiquid instruments or illiquid markets, it may be difficult to dispose of positions promptly. The liquidity of any fund investment is a question of fact that must be addressed on a case-by-case basis; however, advisers may wish to adopt standards for evaluating liquidity for different types of derivatives. Among the factors to consider are

restrictions on transferability, the availability of market bids from multiple sources (including sources independent of the counterparty or placing dealer), the feasibility of entering into offsetting transactions with the same or a different counterparty, and any rights the fund may have to close out the derivative on a marked-to-market basis.

c. Valuation

Mutual funds must value their net assets daily.[39] The 1940 Act provides, in general, that the value of securities for which market quotations are readily available is their market value, and that the value of other securities and assets is their fair value, as determined in good faith by the board of directors.[40] As a practical matter, boards of mutual funds typically adopt policies specifying how securities and assets for which market quotations are not readily available will be valued.

Mutual funds generally should value derivative instruments in the same way that the rest of the fund's portfolio is valued. Thus, derivatives ordinarily should be valued at their market value, based on quotations supplied by an exchange, pricing service or OTC dealer. Derivative instruments for which market quotations are not readily available should be valued pursuant to policies adopted by the board specifying how the fair value of those instruments is to be determined.

Under certain market conditions, pricing of some derivative instruments may present unique issues that should be addressed in a fund's valuation policy. For example, exchange-traded derivatives are subject to limits on the amount that their price may change on a given day. Thus, if the upper or lower limit is exceeded, a fund will have to decide whether to price the instrument at the limit or on some other basis. For OTC derivatives, it may be necessary to reassess the appropriate method of pricing an instrument for which bid/ask spreads become extremely wide, or to develop means for verifying valuations for instruments whose only pricing source is the original dealer or counterparty.

In addition to these issues, consideration should be given to adopting specific procedures for verifying the prices of certain OTC derivative instruments. In this regard, the investment adviser should consider, for example, whether prices are established pursuant to a matrix or model, whether prices quoted by a dealer can be verified by other parties, whether portfolio managers should seek to replicate the pricing of a complex derivative instrument by analyzing its component parts to determine if the price is reasonable, whether analysts or traders should verify prices periodically, and whether accountants should compare the proceeds received upon selling a derivative instrument to the previous night's valuation of that instrument.

d. Diversification

The 1940 Act limits the amount of securities of any one issuer that investment companies classified as "diversified companies" may hold.[41] In the case of certain

derivative instruments, it may not be clear what entity should be treated as the "issuer" of such instruments.[42] In some instances, either the counterparty to the transaction or the issuer of a security underlying a derivative instrument, or both, could be considered issuers to varying extents.

For example, a fund might purchase a note issued by an investment bank, the performance of which is tied to the price of the common stock of an unrelated corporate issuer. The fund would be exposed to the credit risk of both the issuing investment bank and the third party corporation. Therefore, in these or similar circumstances, a fund generally should consider both entities to be "issuers" for diversification purposes.

In addition, as discussed below, similar issues arise under the diversification requirements of Subchapter M of the Internal Revenue Code. The analysis and outcome may differ under tax and securities laws.

e. Custodial Issues

Funds that enter into futurescontracts or that write commodity options must deposit a specified amount of assets or cash as "initial margin" in connection with such transactions. Investors other than funds typically deposit initial margin directly with a futures commission merchant ("FCM"). The 1940 Act generally requires, however, that the custody of a fund's assets be maintained by a qualified bank or broker.[43] Thus, a futures commission merchant generally may not act as custodian. As a result, currently, funds that engage in transactions in futures and options on futures deposit initial margin in special accounts in the name of an FCM with their custodian banks.[44]

To eliminate the need for such "third party" custody arrangements (although they still would be permitted), the SEC recently proposed a new rule under the 1940 Act that would specifically allow FCMs to hold funds' futures margin directly under certain circumstances. Under the proposal, a fund's directors would be required to select FCMs and monitor the arrangements, but could delegate these responsibilities to the investment adviser or fund officers, subject to general oversight requirements.[45]

Another custody-related consideration is that OTC derivative instruments may be evidenced by written agreements, certificates, notes or other physical documentation. Ordinarily, original copies of physical documents that represent fund assets should be held by the fund's custodian, or otherwise safekept in accordance with the requirements of the 1940 Act.

f. Trade Allocation Policies and Procedures

An investment adviser, including the investment adviser to a registered investment company, has a fiduciary duty under the federal securities laws to allocate securities fairly among its various accounts. The investment adviser to a fund that invests in derivatives should consider whether such investments raise any special

allocation issues, or whether existing allocation policies or procedures adequately accommodate these investments. For example, for transactions in futures and options on futures, it may be necessary to identify specific fund beneficiaries at the time a trade is placed, or immediately thereafter.[46]

g. Additional Federal Securities Law Issues

A fund's investments in derivatives also may have implications under several other provisions of the 1940 Act (for example, provisions restricting investments in brokers and dealers, and investments in other investment companies) as well as other federal securities laws (for example, equity ownership reporting requirements under the Securities Exchange Act). Legal and compliance personnel may wish to establish a checklist or other systematic mechanism for verifying the status of particular derivative instruments under applicable law and the fund's own policies.

3. State Securities Law Issues

In addition to complying with the 1940 Act and any other applicable federal securities laws, a fund, unless it is exempted, must comply with the laws of each of the states in which it offers and sells its shares. Some states impose restrictions on the ability of a fund to invest in certain types of derivatives.[47] A fund's legal and/or compliance personnel should review these restrictions, and any undertakings the fund may have made to any state, to ensure that the fund's contemplated investments in derivatives will not violate state law or the fund's undertakings.

4. Federal Tax Issues

Derivatives can present funds with a wide range of tax issues, some of which are described below. Thus, a fund that invests in derivatives must carefully monitor the potential tax-related consequences of those investments.

a. Subchapter M Issues

To qualify for "pass-through" tax treatment under Subchapter M of the Internal Revenue Code, a fund must meet several tests, including a 90 percent gross income test, a 30 percent gross income test, a diversification test and a distribution requirement. Derivatives can present issues under each of these tests, as noted below.

i. 90 Percent Gross Income Test. To meet this test, a fund must derive at least 90 percent of its gross income from various specified sources, including dividends, interest and gains from the sale or other disposition of securities.[48] Income generated by derivatives generally qualifies for these purposes.

ii. 30 Percent Gross Income Test. This test requires that a fund derive less than 30 percent of its gross income from the sale or disposition of certain securities or other instruments held for less than three months.[49] Some

derivatives with short durations, by their terms, will generate "short-short" income under this test. Certain technical tax rules, such as those suspending or terminating an asset's holding period, can also cause derivatives to generate "short-short" income. Disposing of a derivative within three months of purchase will likewise generate "short-short" income.

iii. Diversification Test. This multi-part test is designed to ensure that a fund's assets are sufficiently diversified.[50] In many situations, questions arise regarding who should be treated as the issuer of a particular derivative instrument. As noted above, in some instances, the answer will be different for Subchapter M purposes than for purposes of the diversification requirements of the 1940 Act. Difficult issues regarding the value of a derivative for purposes of tax tests based on "total" assets can also be presented.

iv. Distribution Requirement. A fund must distribute for its fiscal year an amount approximately equal to 90 percent of its net ordinary income and short-term gains and 90 percent of its net tax-exempt income.[51] In addition, funds typically attempt to distribute 100 percent of their income, including long-term capital gains, to eliminate any fund-level tax. To ensure that this distribution requirement is met and that all of its income is distributed, a fund must correctly determine the amount and character of its income on a current basis. Making these determinations with respect to derivatives often requires detailed analysis.

b. Other Federal Tax Issues

Derivatives can present other tax issues as well, including issues affecting the amount and character of a fund's distributions to shareholders. For example, if a derivative is purchased by a tax-exempt fund, it typically is anticipated that the income generated will be tax-exempt. This determination can turn on whether the derivative is structured in a form which, under federal tax law, will permit the income to retain its tax-exempt character when received by the fund.

5. Federal Commodity Law Issues

The Commodity Futures Trading Commission and the National Futures Association (which is a self-regulatory organization akin to the National Association of Securities Dealers) regulate the activities of "commodity pool operators" and "commodity trading advisors". A fund and its investment adviser may fall within these definitions if the fund invests in futures or options on futures.[52]

In most cases, however, funds and their investment advisers are eligible for exclusion from these definitions and, as a result, are not subject to the registration, disclosure and most other requirements applicable to CPOs and CTAs. Specifically, under one such exclusion upon which many funds rely, the fund may invest without limitation in futures and options on futures for "bona fide hedging" purposes, and may

use an additional five percent of its net assets for initial margin and premiums for futures and options on futures positions that are not for "bona fide hedging" purposes.[53] In order to rely on this exclusion, the fund must comply with a number of conditions, including filing a notice with the CFTC and the NFA making certain required representations.[54] There is a similar exclusion for investment advisers.[55]

D. Operational Issues

Fund investments in derivatives can pose numerous operational issues. A comprehensive discussion of these issues is beyond the scope of this memorandum. Some examples of operational matters for investment advisers to consider, however, are set forth below.

Funds that invest in derivatives may need more elaborate recordkeeping and operating policies and systems to handle the multiple actions necessary to initiate and conclude most investment programs involving derivatives. The operational risks associated with derivatives underscore the need for the investment adviser to make sure that systems are in place to coordinate all facets of a derivatives investment program, and that appropriate personnel have the requisite understanding of derivatives. Certain operational risks that need to be addressed include failure to close offsetting derivatives positions, inaccurate recording for accounting purposes, improper handling for taxes and incorrect instructions to the custodian.

Other operational considerations include:

- The need for any special procedures to assure appropriate recordkeeping with respect to derivatives investments.

- The need for coordination and communication with the fund's custodian regarding, for example, whether a particular derivative investment will involve custody of a physical instrument, trade confirmation, purchase agreement or some other evidence of ownership.

V. CONCLUSION

When used appropriately, derivatives can be a valuable investment management tool for funds and provide significant benefits to fund shareholders. Like all investments, however, they pose certain risks. Derivatives markets are continuing to evolve. So, too, are the practices and standards of investment companies participating in these markets. Investment companies should expect increasing scrutiny of fund investments in derivatives by Congress, federal and state regulators, the financial press and the investing public. For these reasons, fund directors and senior management of investment advisers should continue to exercise particular diligence with respect to their oversight and compliance responsibilities in this area.

APPENDIX

Types of Derivative Instruments

Set forth below are descriptions of some common types of derivative instruments.

Options. An option represents the right to buy or sell an underlying asset (often, a security) at a specified time for a specified price. A call option is a right to purchase the underlying asset; a put option is the right to sell it. A fund that buys options has the right to buy or sell the underlying asset. A fund that writes (i.e., sells) options is obligated to sell the underlying asset to, or buy is from, the party that purchased the option (if that party "exercises" the option). A fund that writes an option is paid a premium for doing so. Options can be either standardized or customized and privately negotiated. Some are exchange-listed and others are traded over-the-counter.

Forward Contracts. Funds may enter into forward contracts, which obligate the fund and its counterparty to trade an underlying asset (commonly, foreign currency) at a specified price at a specified date in the future. Forward contracts are traded in the over-the-counter markets.

Futures. Futures are similar to forward contracts, but differ in that they are standardized and traded on a futures exchange. Unlike forward contracts, the counterparty to a futures contract is the clearing corporation for the appropriate exchange. Futures are typically settled in cash, rather than requiring actual delivery of the instrument in question. Perhaps the best known futures contracts are those involving the S&P 500. Parties may also buy or write options on futures.

Swaps. Swaps are over-the-counter transactions that involve two parties exchanging a series of cash flows at specified intervals. In the case of an interest rate swap, the parties exchange interest payments based on an agreed upon principal amount (referred to as the "notional principal amount"). Under the most basic scenario, Party A would pay a fixed rate (e.g., 6%) on the notional principal amount (e.g., $10 million) to Party B, which would pay a floating rate (e.g., LIBOR) on the same notional principal amount to Party A. (Typically, payments between the parties would be netted out and settled periodically.)

In recent years, the swaps market has grown dramatically, both in terms of size and variety. For example, interest rate swaps can involve cross-market payments (e.g., short-term rates in the U.S. vs. short-term rates in the U.K.) and cross-currency

payments (e.g., payments in dollars vs. payments in yen). Floating rate payments may be subject to caps (i.e., ceilings), floors or collars (i.e., caps and floors together).

Structured Notes. Structured notes are over-the-counter debt instruments where the interest rate and/or the principal are indexed to an unrelated indicator (e.g., short-term rates in Japan, the price of oil). Sometimes the two are inversely related (i.e., as the index goes up, the coupon rate goes down; inverse floaters are an example of this) and sometimes they may fluctuate to a greater degree than the underlying index (e.g., the coupon may change twice as much as the change in the index rate).

Structured notes are often issued byhigh-grade corporate issuers. There is often an underlying swap involved; the issuer will receive payments that match its obligations under the structured note (usually from an investment bank that puts the deal together) and, in turn, makes more "traditional" payments to the investment bank (e.g., fixed rate or ordinary floating rate payments). It is important to note, however, that in such cases the mutual fund would not be involved in the swap; the issuer of the note would remain obligated even if its counterparty defaulted.

Mortgage-Backed Securities. The term "mortgaged-backed securities" encompasses a broad array of instruments with differing characteristics. Some of these instruments often are referred to as "derivatives." One such example is stripped mortgage-backed securities, which represent interests in a pool of mortgages, the cash flow of which has been separated into its interest and principal components. Interest only securities ("IOs") receive the interest portion of the cash flow and principal only securities ("POs") receive the principal portion. These securities may be issued by U.S. government agencies or by certain private issuers. Their values are highly sensitive to the rate of mortgage principal prepayments, which tends to increase as interest rates fall and decrease as interest rates rise. When interest rates decline and principal payments accelerate, the interest payment stream is reduced and the value of IOs decreases. When interest rates are rising and prepayments are slower, the average life of POs increases and their value decreases.

ENDNOTES

1. See Dear Registrant (SEC Division of Investment Management No-Action Letter), pub. avail. Feb. 25, 1994.

2. See, e.g., Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning Derivative Financial Instruments, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, United States House of Representatives (May 25, 1994) ("Levitt Testimony"), at 19-20.

3. See Letter from Chairman Edward J. Markey and Ranking Republican Member Jack Fields, House Subcommittee on Telecommunications and Finance, to The Honorable Arthur Levitt, Jr., Chairman, Securities and Exchange Commission, dated June 15, 1994 (the "Markey / Fields letter").

4. Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to fund groups, dated June 16, 1994.

5. Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute, dated June 17, 1994.

6. United States General Accounting Office, Financial Derivatives: Actions Needed to Protect the Financial System (May 1994) ("GAO Report").

7. Levitt Testimony at 21-22 (citations omitted).

8. See Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, at the Mutual Funds and Investment Management Conference, entitled Mutual Fund Directors: On the Front Line for Investors (Mar. 21, 1994), at 4.

9. GAO Report at 10.

10. Id.

11. For example, assume a fund owns 1,000 shares of a German company, which are denominated in Deutschemarks, with a current value of $10,000. If the value of the Deutschemark decreases against the dollar, the value of the German stock also would decrease (in dollar terms). In order to hedge against such a "currency risk," the fund might enter into various transactions. For example, the fund might enter into a currency forward agreement to sell $10,000 worth of Deutschemarks, at today's price, at a specified date in the future. As a result, the fund effectively would have eliminated the currency risk associated with that stock during the life of the forward agreement.

12. For example, assume a fund wished to invest 25% of its assets in the S&P 500. If the fund simply purchased the 500 underlying securities in the same proportions as they are represented in the S&P 500, the fund would be required to continually purchase or sell those securities as the size of its portfolio changed, which potentially could result in significant brokerage and other costs. Another way to achieve substantially the same result, without some of these costs, would be to purchase futures contracts on the S&P 500. If the S&P 500 increases in value, so will the futures contracts. If the S&P 500 decreases in value, so will the futures contracts. As the net asset value of the fund increases or decreases, it may be easier and cheaper to purchase or sell S&P 500 futures contracts than the 500 component stocks. One potential drawback to the use of the futures contracts in such a situation is that the futures contracts will expire after a specified date, and the fund would need to purchase additional futures contracts in order to maintain its S&P 500 position.

13. Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute, dated June 17, 1994, at 1. The Markey/Fields letter also raised specific questions about investments in "sophisticated synthetic derivatives" by money market funds. Markey/Fields letter at 6.

14. See, e.g., Letter from Barry P. Barbash, Director, Division of Investment Management, Securities and Exchange Commission, to Paul Schott Stevens, General Counsel, Investment Company Institute, dated June 20, 1994 (providing additional guidance to money market funds and their advisers concerning SEC and staff positions on issues relating to adjustable rate securities).

15. Letter from Arthur Levitt, Chairman, Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute, dated June 17, 1994, at 2.

16. See, e.g., Items 6(d) and 10(b) of Form N-1A (the registration statement for mutual funds), and Items 8.2.d and 8.3 of Form N-2 (the registration statement for closed-end funds).

17. See Dear Registrant (SEC Division of Investment Management No-Action Letter), pub. avail. Feb. 25, 1994. The staff further indicated that, "if more than 5% of an investment company's assets are at risk from its involvement in derivative instruments and derivative-based transactions," the prospectus should identify the types of derivative-based transactions in which the investment company may engage; briefly describe the characteristics of those transactions or instruments; state the purpose for which the investment company will use derivatives; and identify the risks of derivative instruments and derivative-based transactions. It is not entirely clear whether the staff intended that the 5% threshold apply to all derivative instruments held by a fund in the aggregate or separately to different types of derivatives. See also Item 4 and Guide 3 to Form N-1A; Dear Registrant (SEC Division of Investment Management No-Action Letter), pub. avail Feb. 22, 1993.

18. See, e.g., Securities Trading Practices of Registered Investment Companies, 1934 Act Release No. 10666 (Apr. 18, 1979).

19. Id.

20. See Section 35(d) of the 1940 Act.

21. Guide 1 to Form N-1A provides that if a fund's name "implies that it will invest primarily in a particular type of security ... the [fund] should have an investment policy that requires that, under normal circumstances, at least 65 percent of the value of its total assets will be invested in the indicated type of security ...." Thus, a fund could invest up to 35 percent of its total assets in other types of securities, as disclosed in its prospectus.

22. See Robert McGough, Bond Fund Sets Disclosure Pact On Derivatives, Wall St. J., April 18, 1994, at C1, C15.

23. Letter from G. Oliver Koppell, Attorney General, State of New York, to the Honorable Edward J. Markey, dated July 18, 1994.

24. Id.

25. See Form N-1A, Item 5A.

26. Id.

27. Remarks by Gene A. Gohlke, Associate Director, Division of Investment Management, Securities and Exchange Commission, at the Goldman Sachs Mutual Funds and Derivatives Conference, April 5, 1994.

28. See Article 6-05 of Regulation S-X.

29. Id.

30. See, e.g., Article 12-12B of Regulation S-X; Financial Accounting Standards Board Statement of Accounting Standards No. 105 ("Disclosure of Information About Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Credit Risk").

31. See, e.g., L. Morse, Survey of Derivatives, Financial Times, October 20, 1993, at IV.

32. Section 18(f) of the 1940 Act. In addition, Section 18(a) of the 1940 Act imposes certain limits on the ability of a closed-end fund to issue or sell senior securities.

33. See, e.g., Dreyfus Strategic Investing and Dreyfus Strategic Income (SEC Division of Investment Management No-Action Letter), pub. avail. June 22, 1987; Securities Trading Practices of Registered Investment Companies, 1934 Act Release No. 10666 (Apr. 18, 1979).

34. Id.

35. Id.

36. See Guide 4 to Form N-1A. In the case of money market mutual funds, the staff has indicated that such funds should limit their investments in illiquid securities to less than 10 percent of net assets. See Letter from Marianne Smythe, Director, Division of Investment Management, United States Securities and Exchange Commission, to Matthew P. Fink, President, Investment Company Institute, dated December 9, 1992.

37. Id.

38. It should be noted, however, that in instances in which assets are used to "cover" derivatives positions pursuant to Section 18 of the 1940 Act, the staff may take the position that those assets are illiquid, although it has granted limited exceptions. See, e.g., Prudential-Bache Government Plus Fund II (SEC Division of Investment Management No-Action Letter), pub. avail. Sept. 18, 1987.

39. See Rule 22c-1 under the 1940 Act.

40. See Section 2(a)(41) of the 1940 Act.

41. Section 5(b)(1) of the 1940 Act.

42. See, e.g., Investment Company Institute, ICI Securities Law Procedures Conference (Dec. 1993), at III-13 to III-14.

43. Section 17(f) of the 1940 Act.

44. The staff also has permitted FCMs temporarily to retain excess variation margin gains and has permitted investment companies to pay daily settlement due as mark-to-market payments directly to an FCM. See, e.g., Goldman, Sachs & Co. (SEC Division of Investment Management No-Action Letter), pub. avail. May 2, 1986; Putnam Option Income Trust II (SEC Division of Investment Management No-Action Letter), pub. avail. Sept. 23, 1985.

45. See Custody of Investment Company Assets with Futures Commission Merchants and Commodity Clearing Organizations, 1940 Act Release No. 20313 (May 24, 1994).

46. In May of 1993, the Commodity Futures Trading Commission proposed a rule that would permit certain investment advisers to "bunch" orders for futures or options on futures under certain circumstances, and to allocate the fills for such orders at the end of the day. By letter dated July 21, 1993, the Investment Company Institute submitted a comment

letter generally supporting the proposed rule, and making a number of comments intended to streamline and improve the operation of the rule.

47. See California Corporate Securities Regulations, § 260.140.85.

48. Internal Revenue Code Section 851(b)(2).

49. Internal Revenue Code Section 851(b)(3).

50. Internal Revenue Code Section 851(b)(4).

51. Internal Revenue Code Section 852(a).

52. See generally Section 2(a)(1)(A) of the Commodity Exchange Act (the "CEA").

53. See Rule 4.5 under the CEA. Notably, it is not entirely clear what constitutes "bona fide hedging" in the case of a securities position or portfolio (such as the securities positions and portfolio of an investment company). The CFTC's rules define "bona fide hedging," but that definition is formulated in terms of hedging physical commodities, such as goods that are manufactured or sold, rather than financial futures, such as would be used by an investment company or investment adviser. Thus, the CFTC's definition refers to "transactions or positions [that] normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel, and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise. . . ." (Emphasis added). See Rule 1.3(z) under the CEA.

54. Id.

55. See Rule 4.6 under the CEA. Also, to the extent an investment adviser acts as such only with respect to registered investment companies or certain other "otherwise regulated entities," it may be eligible for the Rule 4.5 exclusion. Other exclusions and exemptions also are sometimes available to investment companies and their investment advisers, although these do not always provide as comprehensive relief from the CPO and CTA requirements as is provided by Rules 4.5 and 4.6.