ROPES & GRAY LLP
PRUDENTIAL TOWER
800 BOYLSTON STREET
BOSTON, MA 02199-3600
WWW.ROPESGRAY.COM

November 7, 2011

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-33-11 -- Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (the "1940 Act")

Dear Ms. Murphy:

This letter is responding to the Commission's recent concept release requesting comments on various issues pertaining to the use of derivatives by registered investment companies. The comments expressed herein reflect the personal views of the undersigned, as practitioners with many years of experience in providing legal counsel to registered investment companies and their investment advisers and boards of directors/trustees. They are not intended to represent the views of other lawyers at this firm nor those of our clients.

In general, the release provides a useful description and analysis of the different uses of derivatives by registered investment companies and the applicable legal and regulatory principles. A number of important considerations now militate in favor of a constructive collaboration between the Commission and its Staff, on the one hand, and the industry and other regulators, on the other, before the Commission proposes new rules in this area. Some of these considerations include:

- *Dodd Frank* -- Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the rules now being proposed by the Commission, the Commodities Futures Trading Commission and other regulatory agencies, are poised to bring about the greatest changes in the regulation of both listed and over-the-counter ("OTC") derivatives in history. That rulemaking process is ongoing and arguably still in the early stages. It will be important that any new Commission positions regarding the use of derivatives by registered investment companies take these changes into account.

- *Complexity* – The derivatives markets have grown and become increasingly complex over the years and will likely continue to do so. Any regulatory regime will need to be flexible enough to grow and change along with the derivatives markets.

- *Lehman Brothers insolvency* – The Commission should take the time to consult with industry and legal resources in order to determine which types of derivatives or derivatives practices led registered investment companies to incur losses in the Lehman Brothers insolvency and subsequent market break.

- *Section 18* – The Commission should develop more fully the legal basis for its regulation of derivatives and design any new regulation in light of that legal basis. Although the Commission has historically relied on a "senior security" analysis to require asset segregation, it is far from clear that Section 18 provides an adequate legal basis for any more substantive regulation of derivatives.

- *Disclosure and oversight* – Disclosure and director/trustee oversight are cornerstones of U.S. regulation of registered investment companies, but neither of these topics receives any significant attention in the release. Any further development of derivatives regulation should carefully consider the role that each of these protections should play.

Regulating the use of derivatives by registered investment companies without unduly discouraging growth and innovation that may benefit their investors is a daunting challenge – especially in light of the quite favorable record of industry use of derivatives to date and the fast pace of current regulatory developments under Dodd-Frank.

<u>Benefits and Risks of Derivatives</u>

As noted in the Commission's release, the use of derivatives by registered investment companies has grown dramatically over recent decades. These instruments have provided fund managers with important tools for gaining investment exposure to particular issuers or asset classes or, conversely, reducing such exposure, often with increased liquidity and reduced transaction costs as compared with direct cash investments. For certain types of funds, derivatives have become integral to the portfolio management process. Despite the rapid growth in the types and volume of derivatives used by registered investment companies, there has been no evidence of widespread misuse of such instruments by fund managers. In fact, the most prominent recent cases involving alleged departures from a fund's stated investment strategy all appear to have involved cash investments. The Commission correctly notes that, under certain circumstances, derivatives may raise questions of compliance with the letter and/or spirit of various provisions of the 1940 Act and the Commission's rules thereunder. However, in the absence of any evidence of widespread misuse of such instruments, the Commission should proceed carefully before imposing additional regulatory burdens and restrictions that might deprive investors of the benefits of these investment tools.

Regulation of Leverage and Liquidity Risks

The Commission's has long recognized that in some cases the use of derivatives may result in increased investment exposure that effectively represents a form of investment leverage. This is not invariably the case, however. In many cases, derivatives may serve to reduce investment exposure. In other cases, derivatives may be used to increase investment exposure, but the resulting overall investment exposure of the fund's portfolio may remain within the bounds of exposure and risk that could be accomplished in the alternative through investments purchased on a cash basis.

In Release 10666 issued in 1979 the Commission noted that the potential investment leverage associated with certain types of derivatives, such as forward commitments, raised questions under Section 18 of the 1940 Act, which prohibits open-end funds from borrowing except from banks and subject to a 300% asset coverage limit. The Commission effectively agreed not to raise this potential compliance issue as long as funds maintained segregated accounts holding liquid assets, "such as cash, U.S. government securities, or other appropriate high-grade debt obligations" equal to the fixed payment obligations associated with these types of derivatives. Such segregated accounts largely eliminate the risk that a fund will be unable to meet its payable obligations in connection with derivatives when due and, as a general matter, also effectively limit the amount of investment leverage that a fund may incur.

As originally conceived by the Commission in Release 10666, such segregated accounts would still have permitted a fund to assume the interest rate risk associated with long-term debt obligations held in segregated accounts and the credit risks associated with "high-grade debt obligations". These risks would be in addition to the risk exposure assumed through the derivative investment. As a practical matter, requiring the segregation of assets but not limiting the permitted segregation to cash equivalents effectively permitted funds to incur investment leverage up to a theoretical limit equal to 100% of a fund's net assets. Thus, from inception the Commission's policies regarding derivatives have not operated to impose limits on investment leverage strictly equivalent to those envisioned by Section 18. However, given the significant practical differences between borrowings and derivatives in many situations, is it not clear that there is any need for precise alignment between the two regulatory regimes.

The Staff's subsequent no-action letter issued to Merrill Lynch in 1996 provided greater flexibility by allowing a fund to segregate any liquid assets, including equity securities and non-investment grade debt -- thus potentially expanding the nature of the investment leverage risks associated with derivatives.

As noted in the Commission's release, industry practice has evolved further since 1996 in a manner that could, in some instances, allow for investment leverage that exceeds the 100% limit that was implicit in earlier Commission and Staff positions. It now appears to be an increasingly common practice for funds that engage in cash-settled swaps to segregate assets only to the extent required to meet the fund's daily mark-to-market liability, if any, relating to such swaps. Of course, in many cases this liability will not fully reflect the ultimate investment exposure associated with the swap position. As a result, a fund that segregates only the market-to-market liability could theoretically incur virtually unlimited investment leverage using cash-settled swaps. The Commission's release notes that this practice has not been endorsed by the Commission nor by the Staff in no-action letters. However, we believe that the Staff has been well aware of this practice for some time and understand that certain members of the Staff have provided favorable informal guidance on occasion regarding this more limited form of segregation.

In practice, it appears that the industry has generally used this enhanced flexibility in a responsible fashion. It is important to note that a fund that engages in investment leverage, whether through conventional borrowing arrangements specifically contemplated by Section 18 or through the use of derivatives within the parameters of existing Commission and Staff guidance, has a clear obligation to disclose this investment strategy and its associated risks in its prospectus documents and marketing materials. In addition, as noted by members of the Commission and the Staff on many occasions, fund directors/trustees also have important oversight responsibilities with respect to the use of derivatives that, among other things, include monitoring a fund's use of derivatives for leverage purposes. Absent any indication that funds are not making adequate disclosures in this regard, or that directors/trustees are not fulfilling their oversight responsibilities, there is no compelling reason at this time for the Commission to being imposing new restrictions on the use of derivatives. However, should the Commission decide to impose more restrictive segregation requirements in connection with cash-settled swaps, we believe that these should be no more restrictive than those required by the Staff in the Merrill Lynch letter. Any further limitation on the ability of registered funds to engage in derivative transactions should only be considered by the Commission after careful consideration of the potential costs to investors and after ample public exposure of any such proposed restrictions for public comment.

<u>Regulation of Issuer and Industry Exposures</u>

The Commission's release observes that the ordinary process for measuring investment exposure for purposes of compliance with diversification and industry concentration polices may become problematic when a fund acquires investment exposure through the use of derivatives. The potential problem is demonstrated by the following examples:

Example 1 -- Fund A has total assets of $100 million which are invested in a diversified portfolio of equity securities. Fund A then borrows $50 million from a bank which is then invested in additional equity securities. In this case, the calculations for compliance with the diversification limits of Section 5(b) of the 1940 are clear and simple. Fund A now has "total assets" of $150 million and those individual equity investments subject to the 5% limitation of Section 5(b) may not exceed $7.5 million in each case at the time of purchase.

Example 2 – Fund B also has total assets of $100 million invested in a diversified portfolio of equity investments. Fund B then enters into swap agreements providing notional exposure to $50 million of additional equity securities. If the compliance computation is based solely on market value, it arguably fails to account in an effective way for the investment exposure incurred through the swap agreements since these agreements have zero market value at the outset and any market value thereafter will not be indicative of total investment exposure.

As is evident from these examples, one way to align the diversification calculations in these two situations would be to include the notional amount of the swap agreements both in calculating total assets and in calculating the exposure to a particular issuer. The same general principle would seem to apply when considering how to calculate exposures for purposes of industry concentration policies. There may, however, be other approaches that would serve to address the statutory policies underlying the requirements of the 1940 Act regarding diversification and industry concentration.

The Commission's release suggests that in certain instances it may also be appropriate to identify the counterparty to a derivatives transactions as the "issuer" of the derivative for purposes of compliance with diversification and industry concentration policies, as well as the limitations on investments in securities-related issuers under Section 12(d)(3) of the 1940 Act. This would seem to be more of a theoretical, rather than a practical issue. As a practical matter, the fund is not entering into the derivative transaction for the purpose of seeking to gain exposure to the investment performance of the counterparty, and the credit risk associated with the derivative transaction becomes relevant only in the limited circumstance where the prospect of insolvency ceases to be remote. Thus, under normal circumstances, treating the counterparty as the issuer of the derivative for compliance purposes vastly overstates that true investment exposure of the fund. Moreover, the current movement toward collateralization of OTC derivatives and the regulatory pressures to move such derivative trading to clearing houses, should greatly reduce the magnitude of counterparty risk associated with the use of OTC derivatives across the industry. Finally, as a practical matter, it seems highly unlikely that the vast majority of registered investment companies would ever have sufficient exposure to derivatives counterparties so as to exceed the percentage limitations imposed by their diversification and industry concentration policies.

Insofar as Section 12(d)(3) is concerned, it is difficult to see how the limited counterparty exposures relating to OTC derivatives would be pertinent to the original legislative policies underlying the limitation on investments in securities-related businesses. Given the questionable relevance of these legislative policies in today's market environment, the Commission should address any perceived technical conflicts between the use of OTC derivatives and the requirements of Section 12(d)(3) and the rules thereunder through appropriate exemptive rules that recognize the effectiveness of clearing and collateral arrangements in minimizing risk exposures.

Process for Further Guidance/Rule-Making

In view of the many other changes occurring in the regulation of markets generally and the trading of derivatives in particular, the Commission should proceed carefully before imposing additional regulatory burdens on the use of derivatives by registered investment companies, especially in light of the lack of any evidence of wide-spread abuse of the flexibility provided by existing Commission and Staff guidance or of any significant harm to investors from existing industry practices. As noted above, we strongly encourage the Commission to consult extensively with all affected industry participants prior to embarking on new rule-making efforts or issuing regulatory guidance in this area. To the extent that the Commission determines to implement new regulatory requirements that are more restrictive than existing Commission and Staff guidance (whether formal or informal), the Commission should provide ample advance notice of any such new requirements and reasonable compliance deadlines.

Very truly yours,

John W. Gerstmayr

Gregory D. Sheehan

Timothy W. Diggins

Bryan Chegwidden