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E. Russell Ives, Jr.
President

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VIA ELECTRONIC DELIVERY

Ms. Elizabeth M. Murphy
Secretary
U. S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Release No. IC-29776, File No. S7-33-11

Dear Ms. Murphy:

Ives Associates, Inc. is pleased to have the opportunity to submit this letter in response to a request by the Securities and Exchange Commission ("SEC") for comment on the above referenced Concept Release. The objective of the SEC to assure that investors are adequately protected when sponsors use derivatives for leverage is clearly presented.

Further, the Concept Release elicits the kind of formative thinking that is required of a subject that has a broader range of application than most realize. With that in mind, this correspondence serves to emphasize that the key to adequate investor protection from derivatives use is not necessarily the extent of use, but how they are utilized. That view is supported below by a description of a very different investment strategy that would use derivatives to create a new class of debt product, not by acquiring leverage, but by conveying it to others.

My interest in this subject arises from earlier experience at a major investment bank where I headed relationship management for the Government Sponsored Enterprises ("GSEs"). Now, I focus on the development of new ideas to facilitate financial markets participants' adapting to reform. Because reform sharply curtailed most wholesale credit intermediation, supply conditions for short term product are tight and will likely worsen as BASEL III is implemented. Liquidity investors need a new product that potentially can be sourced in large scale. If allowed in an exchange traded fund, derivatives could be used for risk transference to create an alternative collateralized debt product with the safety and stability of a portfolio of reverse repos.

It is in the latter context that I am responding to SEC interest in this investment strategy which apparently had not been seen before: ***an exchange traded fund that relies significantly, indeed exclusively, on derivatives to create a portfolio that has neither leverage nor market risk.*** This letter provides an overview of that strategy and attempts to demonstrate that the adequacy of investor protections should not depend on the significance of derivatives use.

The objective of the unique derivatives strategy explained below is to create a collateralized deposit alternative that will help to attract global liquidity investors to an exchange traded product in large scale for the first time.

As is common practice, sponsors typically use derivatives to increase returns for shareholders by adding market risk through the leverage from buying swap investment exposures. Even with inverse funds, managers use derivatives with the same objective, but instead, they sell derivatives to profit from short positions. Such use of derivatives to increase leverage and market risk has been a source of SEC concern for the adequacy of investor protections.

In stark contrast is an ETF that uses derivatives for risk transference to insulate its shareholders from market risk and the impact of leverage. Reliance on derivatives to create a portfolio with no market risk or leverage results in safety and stability and exceptionally well-protected shareholders. That outcome is the objective of the investment strategy and should not give rise to the need for added protection. As long as derivatives are not used to increase leverage and market risk, such strategies could safely be considered for allowance now while other matters continue to be evaluated.

In order to provide investors with new opportunities that are needed in this current investment climate and are consistent with adequate protections, perhaps the SEC might refine its concerns on derivatives use for leverage and increased market risk. Then the SEC could be positioned to consider for approval those strategies whose derivatives positions are used otherwise.

One example of such a strategy is a portfolio with no market risk, achieved by holding fully offset derivatives positions. To the best of this writer's knowledge, there has never been a fund designed exclusively to sell derivatives investment exposures that it fully offsets. In this case, leverage and market risk are transferred to the fund's end counterparties. (The thinking for this method for managing an investment company is the subject of USPTO issued Pat. No. 8,121,925.)

A distinction of this ETF strategy is that there is no active portfolio management in the traditional sense. Activity is initiated by an approved counterparty who requests to buy a swap based on an approved asset class such as agency mortgage backed securities, for example. That request triggers the fund's purchase of that specific asset and the swap execution, as arranged by a fund authorized participant. As one observer noted accurately, this ("offset at the outset") approach assures that there is no fund shareholder leverage or market risk. The net result is a portfolio of short derivatives positions offset 100% by physical cash positions in the swap reference assets purchased by the fund. Such a portfolio is economically equivalent to a portfolio of reverse repos (which would be readily allowed, but with different documentation).

Effectively, the ETF could be characterized as a collateralized deposit alternative—exactly what global liquidity investors need for this investment environment—safety, stability and liquidity. The primary portfolio risk to the ETF shareholder would be overnight collateralized counterparty credit risk.

Counterparties facing the fund would likely be very high quality—one or more primary dealers or GSEs who have access to either central bank liquidity or public sector guarantees. They would likely be intermediating to a diversified pool of end swap investors, including hedge funds. The intermediaries would add their imprimatur to the swap obligations of the end investors who would rely on their own capital to absorb the customary ownership risks of the swap reference assets and to supply margin for intermediaries to pass through to the fund, functionally comparable to capital.

Based on (i) two levels of swap counterparty protection back to back; (ii) collateral which might be Government backed on its own; and (iii) swap margin with daily remargining, the net asset value of the ETF will be stable and safe with no market risk and the risk of a run would be mitigated. The swaps not only guarantee both stability and income, but also may enable a swap rate that assures market-based share liquidity, transferring that risk to counterparties. These features, combined with fund liquidity and share redemption/issuance arrangements, will provide the ETF's authorized participants with the backing they need to maintain daily stable value pricing for the shareholders in the secondary market.

Dealers should be very motivated to use swap based funding because it improves capital efficiency by better aligning capital to risk versus traditional debt or repo. Reduced capital costs lead to increased trading capacity where, in the course of providing liquidity to markets, dealers use financing as an incentive to facilitate customer trades in addition to funding their own positions. For example, when a dealer sells a position from inventory to a customer who buys with dealer repo financing, the market risk transfers to the buyer. As a result, the dealer's regulatory risk based capital requirement and real economic capital requirement both drop to a de minimis level. Unfortunately, the dealer's balance sheet does not change and requires a GAAP equity capital allocation the same as before when it owned the asset and the market risk. This excess allocation of capital is expensive (200 basis points is the equity related component of an all-in-cost for balance sheet matched repo positions, based on a 10% equity allocation and a 20% pretax target ROE).

In contrast, matched swaps save the excessive GAAP capital allocation through non-cash execution but still attract the same regulatory risk based capital for counterparty risk. The redeployed capital will increase dealer shareholder returns. Additionally, dealer customers will benefit from a new source of funding and from better performance metrics, assuming a swap is used on the buy side.

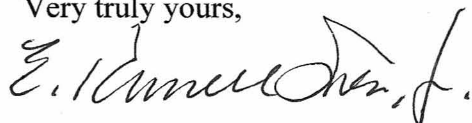
Aside from the advantages for ETF liquidity investors, dealer banks and their investor customers, allowance for the proposed use of derivatives could also benefit the GSEs and the Federal Reserve System. As an intermediary, a GSE could develop a transitioning option to increase mortgage backed securities liquidity and trading, with very low risk matched swap positions. And the Fed would gain from (i) the increased capacity of its primary dealers to enhance market liquidity and to implement monetary policy; (ii) the reduced systemic risk of less reliance on repo markets and (iii) an alternative and more efficient means for eventually selling its mortgage backed securities portfolio.

These are meaningful benefits for a wide group of financial markets participants all attempting to adapt to reform. Respectfully, both the public and private sectors of our economy could have an opportunity to achieve these benefits if the SEC lifted the moratorium for investment strategies that do not use derivatives for leverage and increased market risk. Doing so would allow new investor opportunities and at the same time assure adequate investor protection.

I appreciate very much the interest in this approach to derivatives use and the idea to submit a letter. While not conforming to the specifics of the Concept Release, it was written to present an example of derivatives use that, because of its different approach, emphasizes the need to look beyond the mere use of derivatives to the rationale for their use. I am hopeful that this letter presents a persuasive case that the extent of derivatives use alone should not be cause for concern or unwillingness to provide relief for a proposal. It is the rationale for use that has the potential to give rise to concern for investor protection that is commensurate with the risks assumed.

If you have any questions or require more information, please do not hesitate to contact me.

Very truly yours,



cc: The Honorable Mary L. Shapiro
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Troy A. Paredes
The Honorable Elisse B. Walter

Ms. Eileen Rominger, Director
Division of Investment Management