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December 22, 1977

Act	ICA-40
Section	17(f)
Rule	
Public Availability	3/9/78

Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549

Att: Alan Rosenblat, Chief Counsel
Division of Investment Management

Re: Merrill Lynch Capital Fund, Inc.:
Request for Interpretive Ruling under
Section 17(f) of the 1940 Act

Dear Sir:

We are counsel to Merrill Lynch Capital Fund, Inc. ("Capfund"), and as such are writing to you on behalf of Capfund to seek further clarification of the guidelines under the Investment Company Act of 1940 for the lending of portfolio securities by registered investment companies. These guidelines were first enunciated in an interpretive response on December 27, 1971, to State Street Bank and Trust Co. and have been elaborated on in a series of subsequent responses, the latest being the response of the Staff of May 4, 1974, to Salomon Brothers. I have spoken to Mr. Craig Sparks of your office regarding this matter and he suggested that we write this letter.

The guidelines permit either cash or marketable securities issued or guaranteed by the United States Government or its agencies to be used as collateral in connection with loans of portfolio securities. When the borrower deposits with the lender marketable securities as collateral, the borrower pays the lender a loan premium computed as a percentage of the daily market value of the loaned securities. Any yield on the deposited securities is for the account of the borrower. When cash is deposited with the lender as collateral, the lender invests the cash in "high yielding short-term investments which give maximum liquidity to pay back the borrower when the securities are returned." In this type of arrangement, the lender must look to the investment return on the cash collateral as its compensation for loaning its portfolio securities.

It has been the experience of Capfund that borrowers of securities may prefer to use the arrangement whereby cash is delivered to the lender as collateral for the borrowed securities. Guideline 4 provides that the lender of portfolio securities must receive reasonable interest on loans of its portfolio securities and imposes upon the directors of such fund the duty of making the determination that the overall compensation received by the fund in consideration for lending its portfolio securities is reasonable and desirable in view of the risks involved in making such determination taking into account prevailing interest rates and other factors effecting the overall return to the fund.

If a fund is required to segregate the cash collateral received in connection with a securities loan, it is conceivable that the fund might realize capital losses on the sale of the marketable securities in order to pay back the borrower when the securities are returned. These capital losses, which would reduce the overall rate of return to the fund on any loan of its portfolio securities, would be attributable primarily to the effect of fluctuating interest rates on the face amount of such marketable securities at the time the loan is called. The return to the fund would be even further reduced by the fact that all borrowers involved in loans of portfolio securities who use the cash collateral arrangement insist on receiving some return on the collateral posted for the stock loan, generally a fraction of the return being earned on the collateral by the lender, e.g. 1/2 the rate of return received by the lender as interest on the collateral. In any event, such segregation would reduce the flexibility of management and would likely reduce the return to the fund.

The uncertainty with respect to the rate of return on a portfolio securities loan created by fluctuating interest rates coupled with the possible necessity of having to sell marketable securities prior to their maturity date on account of the loan being called makes it difficult for a fund and its directors to comply with the requirements of Guideline 4, particularly with respect to the determination that the fund receive reasonable compensation in consideration of loaning its portfolio securities in view of the risk involved. The possibility that the fund may realize capital losses on the sales of marketable securities held as collateral for portfolio loans obviously increases the risk to the fund in making such loans and may preclude the fund from making such loans.

Management of Capfund believes that these potential problems could be eliminated if such collateral were permitted to be commingled with the general cash and other liquid assets of the fund. Under this proposal, the fund would commingle the collateral received by it for portfolio securities loans with the general liquid assets in its portfolio. The fund's investment advisor, under the supervision of the Board of Directors of the fund, would invest such cash in such short-term investments as it deemed appropriate to properly balance this portion of the fund's portfolio in order to accomodate the cash needs of the fund, including cash required for redemptions and to repay collateral on portfolio loans. The need to liquidate investments at an inopportune time for the purpose of paying back the borrower when the loan is terminated would be minimized, if not entirely eliminated, since the fund presumably would have sufficient cash on hand or, if cash were not readily available, marketable securities having a maturity date closer to the time of termination of the loan which could be liquidated to raise the necessary cash.

Section 17(f) of the Investment Company Act of 1940 requires every registered management investment company to maintain its portfolio securities and other investments in the custody of a qualified custodian and authorizes the Commission to adopt rules and regulations with respect to the segregation of such securities and investments. The rules adopted by the Commission under such authority embody the philosophy that the securities and investments held in custody are to be segregated from securities and investments of any other person and marked to identify them as the property of such investment company. Although collateral delivered to Capfund for the purpose of securing loans of its portfolio securities presently is segregated by its custodian from Capfund's general assets, the philosophy expressed in the rules promulgated under Section 17(f) would not appear to be violated if collateral were commingled with the fund's assets. Capfund's assets held by the custodian would not be subjected to any greater risk by having the custodian also hold such collateral with the fund's other assets.

No provision of law of which we are aware, including Section 17(f), expressly prohibits such commingling of collateral with fund assets. In the Staff's response dated May 22, 1972, to the State Street Bank and Trust Co.'s letter of inquiry the Staff indicated that it would not require that collateral comprised of short-term securities held by an investment company in connection with loans of its portfolio securities be separately segregated from the other short-term securities of the fund. The present proposal is merely an extension of this principle to permit commingling of cash collateral received to secure loans of portfolio securities with the cash and marketable securities of the fund.

The borrower's interest in the collateral would continue to be protected if the cash collateral were commingled with cash or marketable securities of the fund, subject to the lender's duty to use reasonable care in the custody and care of the collateral in its possession. Since the Uniform Commercial Code contemplates that fungible collateral may be commingled, the borrower's rights in the collateral would not be adversely affected by commingling the collateral with other cash assets of the lender.

This proposal would permit Capfund greater flexibility in selecting among the various brokers who borrow portfolio securities, and would afford the fund more opportunity to maximize the investment return on cash collateral. The higher yield resulting from the return on such collateral would accrue directly to the benefit of Capfund's shareholders. Capfund's investment advisor also would be provided with additional cash flow which would be useful in managing the cash and marketable security needs of the fund.

On the basis of the foregoing, it is our opinion that the commingling of cash collateral received in connection with loans of portfolio securities with the cash and marketable securities of the fund, under circumstances where the guidelines established by the Staff of the Commission with respect to loans of portfolio securities are otherwise complied with, would not result in the violation of any provisions of the Investment Company Act of 1940, as amended, or any of the rules and regulations promulgated thereunder.

We would appreciate your advice as to whether you concur in our opinion based on the facts set forth in this letter.

If you have any questions concerning this matter, please communicate with the undersigned or, in his absence, Denis R. Pinkernell of this firm.

Very truly yours,

Robert L. Losey

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Robert L. Losey

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 77-1274CC
Satterlee & Stephens
File No. 132-3

February 7, 1978

Based on the facts and representations above, we would not recommend any action under Section 17(f) of the Investment Company Act of 1940 if cash collateral received by Merrill Lynch Capital Fund, Inc. ("Capfund") in connection with loans of its portfolio securities is commingled by Capfund's custodian with Capfund's cash and marketable securities so long as (1) the loan agreement allows such commingling and (2) the guidelines established by the staff with respect to loans of portfolio securities are complied with.

Stanley B. Judd

Stanley B. Judd, Assistant Chief Counsel
Division of Investment Management

ETT:hbg

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