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November 7, 2011

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

Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (File Number S7-33-11)

Dear Ms. Murphy:

T. Rowe Price Associates, Inc. appreciates the opportunity to comment on the Securities and Exchange Commission's concept release issued by the Securities and Exchange Commission (the "**SEC**") on the above-referenced subject (the "**Release**").[1] Investing in derivatives can be a valuable portfolio management tool, which facilitates a mutual fund's ability to achieve its investment objectives. However, because derivatives can be complex instruments, the application of certain regulatory requirements to these instruments under the Investment Company Act of 1940 (the "**1940 Act**") raises interpretive issues. As a result, we support the SEC's efforts to gather information through the Release and would welcome additional guidance that ensures that the regulatory framework for the use of derivatives by mutual funds is clear, working as intended, and serving the interests of shareholders.

We support the views expressed in the comment letter regarding the Release filed by the Investment Company Institute ("**ICI**"). We are also writing to detail our recommendations on certain matters concerning the Release.

Summary of Recommendations.

- In terms of general considerations, we believe the issuance of new guidance under the 1940 Act regarding derivatives should take place after completion of the derivatives-related rules required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").
- With respect to asset segregation (also known as asset coverage), we advocate defining "leverage" to mean indebtedness leverage. We also strongly support a principles-based approach that determines asset coverage based on realistic determinations of expected potential future liability of a fund's derivatives exposure.

[1] T. Rowe Price Associates, Inc. and its affiliates serve as investment advisers to numerous individuals, institutions, and investment funds, including the T. Rowe Price family of mutual funds. T. Rowe Price currently sponsors over 120 mutual funds. As of September 30, 2011, T. Rowe Price Associates, Inc. and its affiliates managed over $453 billion in assets.

- As a supporter of a principles-based approach to asset coverage, we also believe it is imperative that this approach be accompanied by robust disclosure requirements in order to be effective.
- Our recommendations for issuer diversification, industry concentration, and Rule 12d3-1 of the 1940 Act focus on measuring these limits based on the derivative's underlying reference asset(s) as opposed to the counterparty. We believe counterparty risk issues would be best dealt with through new rules specifically designed to address these issues. Additionally, derivatives which are centrally cleared and/or exchange traded should not be subject to counterparty limits.

In the sections below, we provide additional details regarding these topics and related recommendations.

General Considerations. Given the significant changes in the regulation of derivatives under the Dodd-Frank Act, any new 1940 Act guidance relating to derivatives should take place after completion of the Dodd-Frank Act's derivatives-related rulemakings. Having the benefit of final rules being in place and observing how the market operates in the new environment would help the SEC craft sound guidance in this important area.

From an oversight standpoint, a summary of the fund's asset segregation, diversification/concentration, and counterparty policies (collectively, "**Derivatives Principles**") should be approved by its board as part of the fund's compliance program under Rule 38a-1 of the 1940 Act and described in reasonable detail in the fund's Statement of Additional Information.[2] Moreover, we believe that a principles-based approach should be accompanied by robust disclosure to fund investors regarding how the fund measures exposure for each type of derivative and whether netting of positions is permitted, what types of assets are eligible for asset coverage, and the amount of coverage assets necessary. Disclosure is especially important so that shareholders, analysts, and other interested parties can properly assess a specific fund's risks since, by its nature, a principles-based approach accommodates some variation in practices.

Although not specifically addressed in the Release, as a related matter we believe there is a need for updated guidance on the custody requirements under the 1940 Act so that there is a clear and logical framework for derivatives and certain other instruments, such as bank debt and private placements.

Asset Segregation. We support the concept of asset coverage for mutual funds as an effective way to serve the investor protection goals of Sections 1 and 18 of the 1940 Act. Section 18 imposes restrictions on a fund's issuance of "senior securities". A senior security can take many forms, but for purposes of coverage requirements, it is defined as any security constituting

[2] In addition, funds should be required to annually review the Derivatives Principles with the fund board and any changes to the principles which would be deemed to materially increase risks to fund shareholders should also be subject to board approval. In connection with the board's annual review, the adviser's Chief Risk Officer (or such officer's designee) or the fund's Chief Compliance Officer should be required to deliver an annual report on the operation of the Derivatives Principles.

indebtedness. Indebtedness can be defined as an obligation of the fund to pay in the future for something that is currently received. This type of indebtedness generally results in leverage.

The SEC's purposes for imposing asset coverage requirements are two-fold. First, these requirements act as a practical limit on the amount of leverage undertaken by a mutual fund. Second, asset coverage helps ensure the availability of adequate funds to meet future obligations stemming from indebtedness. Given these purposes, we support the SEC clarifying that leverage only refers to indebtedness leverage and, therefore, excludes economic or investment leverage. In this regard, we believe investment leverage should be appropriately addressed by other elements of a fund's risk management, compliance and disclosure controls regarding derivatives.

Like the ICI, we view the guiding principle behind asset coverage to be that a fund must have assets available to meet all of its obligations <u>based on a realistic and reasonable expectation</u> of the fund's potential liability. As a result, under a principles-based approach which measures a fund's obligations in this manner, using an amount for coverage other than the notional or mark-to-market value of the derivative could often be appropriate.[3] A fund's Derivatives Principles should explain the characteristics of the derivatives instruments that require asset coverage, how such characteristics impact the appropriate level of coverage, and the types of fund assets eligible to be used as cover. In our view, all liquid assets should be considered suitable for coverage, however, a fund should consider whether the volatility of certain liquid assets warrants a discount or "haircut" and disclose the basis for such determinations. Any collateral posted regarding a derivative should also count towards the asset coverage for such derivative.

Under a principles-based approach, the SEC should also acknowledge that it is possible for a fund to conclude that in certain cases, transactions that are not identical can be offset for coverage purposes (factors that may impact this conclusion are the credit quality of the counterparties, expected correlation between the two transactions, etc.). We also believe that a derivative generally should not require additional asset coverage merely because it settles physically as opposed to employing net cash settlement. However, under a principles-based approach, a fund should regularly review its derivatives holdings and consider whether certain market or operational conditions exist which would warrant distinguishing between net cash and physical settlement for purposes of determining certain derivatives' segregation requirements.

Issuer Diversification & Industry Concentration. Under section 5(b) of the 1940 Act, a fund must calculate the value of its investments as a percentage of its total assets in order to determine whether it meets certain diversification tests. The rationale for this provision is that, in the case of diversified funds, the performance of the fund's investments should not be overly tied to the success of a few issuers. In the case of derivatives, typically most (if not all) of the derivative's value is based on the reference asset. In addition, the presence of a counterparty does

[3] Under a principles-based approach, value-at-risk models are examples of tools which may form the basis for a fund's conclusion that the amount of coverage for certain derivatives ought to be less than the notional amount. However, funds should have the discretion to determine the models and/or other rationales supporting such a conclusion and the coverage amount for such derivatives.

not create additional positive returns. As a result, it is appropriate to focus on the reference asset when measuring issuer diversification.[4]

We believe the objectives of the 1940 Act's industry concentration provisions are similar to those for issuer diversification. As a result, we are also in favor of only taking into account the reference asset for industry concentration. Since the reference asset may represent the same issuer or be in the same industry as direct holdings of the fund, we think the SEC ought to articulate in its rules or provide industry guidance on how these exposures get combined and measured (i.e., market values) for purposes of these limits.

Counterparty Considerations. Although the NAV of a fund is typically not impacted by its derivatives' counterparties, managing counterparty risk exposure is crucial because of the additional credit risk counterparties introduce. The activities of, and the fund's exposure to, a derivative counterparty are not dependent on, and have no relation to, the counterparty's industry. As a result, we don't believe that Rule 12d3-1 is well-positioned to provide an optimal framework for managing counterparty risk since it applies only to "securities-related issuers" and it is designed to address different purposes than the regulation of counterparty exposure.

Therefore, we recommend that the SEC establish a new counterparty rule which requires diversified and non-diversified funds' Derivatives Principles to include: (a) policies and procedures for the periodic review and approval of a fund's derivative counterparties, and (b) a principles-based model that requires the fund's adviser to establish, subject to fund board approval, measurable limits on derivative counterparty exposure that would be monitored by adviser and reported to the board annually as part of the fund's compliance program. In developing such a rule, it may be helpful to evaluate guidance from other regulatory frameworks for pooled investment funds such as an "undertaking for collective investment in transferable securities" (known as "UCITS") which impose constraints on total counterparty exposure.

In this regard, we believe that certain aspects of Rule 12d3-1 and its purposes are no longer consistent with the operations of modern securities businesses. Accordingly, the SEC should consider modernizing Rule 12d3-1 in the event it proceeds with a separate counterparty exposure rule as described above. Specifically, the SEC should (a) retain Rule 12d3-1's prohibition on investments in securities of the fund's adviser and affiliates; but exclude unaffiliated investment advisers from the definition of "securities-related issuers"; and (b) in the context of derivatives, exclude the fund's credit exposure to derivatives counterparties from Rule 12d3-1's application altogether, and limit it to the reference assets and other direct investments in securities-related issuers.

We also request that the SEC clarify that derivatives that are cleared and/or exchange-traded are not subject to counterparty limits. Although we do not advocate specific limits on the use of clearinghouses and exchanges, we recommend that any new derivatives rule-making by the SEC under the 1940 Act include principles-based guidance regarding the review of

[4] In our view, this approach also best serves two objectives of the diversification and industry tests; namely, informing shareholders of the character of the portfolio of the fund and preventing funds from substantially changing that character without shareholder approval.

clearinghouses' and exchanges' capabilities and structure, as well as their appropriateness for use. Lastly, we believe that the SEC should acknowledge that when establishing counterparty limits, a fund can consider the extent to which collateral is posted by the counterparty, the derivative's contractual provisions (such as netting, early termination, etc.), the length of the derivative's term, and counterparty credit quality, among other factors as reasonably determined.

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We appreciate your consideration of our views on this significant topic. If you have any questions or would like to discuss our letter, please do not hesitate to contact us.

Sincerely,

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