BlackRock

November 4, 2011

VIA ELECTRONIC FILING

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

This letter responds to the request of the Securities and Exchange Commission (the "Commission") for comment on the use of derivatives by management investment companies registered under the Investment Company Act of 1940 (the "Act") and other issues discussed in the concept release (the "Release"). BlackRock, Inc. ("BlackRock")[1] commends the Commission for seeking to better understand and potentially address issues that arise from use of derivatives by managed investment companies. BlackRock believes that, used appropriately, derivatives can be effective tools in seeking to achieve returns and control risks in funds. Derivatives raise a number of interpretative issues under the Act and Commission rules, however. BlackRock strongly supports the Commission's goal of reconsidering, and potentially clarifying, the regulations and interpretations of the Commission staff applicable to derivatives based on the experience of the investment company industry. Our comments regarding the Commission's approach to regulating derivatives use by funds focus on the following themes:

- The Commission should adopt a risk-based approach to determining the amount of liquid assets a fund would be required to set aside against contingent liabilities resulting from the use of derivatives;

[1] BlackRock is one of the world's largest asset management firms. We manage $3.6 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, mutual funds and exchange-traded funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world. In the United States, BlackRock is the sponsor of several hundred open-end mutual funds (including money market funds), closed-end funds and exchange-traded funds collectively with assets of over $900 billion as of September 30, 2011. Some of these funds utilize derivatives in their portfolios.

- The Commission should clarify the applicable custody requirements under Section 17(f) of the Act relating to use of margin in light of the central clearing of swaps required under the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"); and
- The Commission should permit exchange-traded funds ("ETFs") to be able to use derivatives in the same manner as other funds, subject to a cap on derivatives exposure and transparent disclosure of the use and risks of the strategies employed.

"Leverage" and Asset Segregation

The term "derivatives" applies to a wide variety of financial instruments the value of which is based upon, or derived from, some other underlying measure of value ("reference asset") which may be a financial instrument, an index or a payment amount (such as an interest rate or interest rate benchmark). Derivatives may be highly standardized exchange-traded instruments, or highly customized over-the-counter bilateral contracts between sophisticated parties. The wide variety of derivatives leads to a correspondingly wide variety of applications by funds. These include:

- Hedging – the use of a derivative to mitigate some or all of the risk inherent in physical positions held in a fund portfolio, such as purchase of a put option on a stock to provide downside price protection, use of an interest rate swap to shorten the duration of a bond portfolio or the sale of a currency forward to reduce the currency exposure of a bond denominated in a currency other than US dollars;
- Equitization – the use of a derivative to provide exposure to a benchmark, asset class or investment in a manner that provides for quicker or more cost-efficient execution than purchase of physical securities, such as the purchase of a stock or bond index future by a fund to obtain immediate index exposure and reduce "cash drag"[2];
- Synthetic Positions – the use of a derivative (potentially together with other assets in the portfolio) to create an attractive position that cannot readily be duplicated through a readily available single investment, such as coupling a ten-year treasury bond with sale of a credit default swap on Company A to create the equivalent of a ten-year debt security of Company A when Company A does not have ten-year debt securities outstanding;
- "Market Neutral" Strategies – the use of derivatives to create positions that are "long" an exposure and "short" a similar (but not identical) exposure to exploit potential performance differences between the exposures while limiting overall market risk.

Derivatives allow a fund to increase, decrease or change the levels of risk to which the portfolio is exposed in a manner that may be more cost-effective, tax-efficient or provide greater liquidity than replicating the same exposures through traditional securities. In many of the strategies for which derivatives are commonly used (including hedging and market neutral strategies), the derivatives are paired with other holdings in a fund's portfolio and their effect on the portfolio cannot properly be understood without reference to such other holdings.

[2] Cash drag refers to a fund's relative underperformance against a benchmark as the result of a fund holding cash and therefore not being as fully exposed to the asset class as the benchmark.

The Commission has historically regulated investment by funds in derivatives under Section 18 of the Act, which imposes limits on funds' capital leverage. The Commission notes that a "common characteristic of most derivatives is that they involve leverage," which the Commission defines as "the right to a return on a capital base that exceeds the investment which [the investor] has personally contributed to the entity or instrument achieving a return."[3] As the Commission correctly observes, however, this definition of leverage covers both instruments that achieve leverage by creating potential future obligations, or indebtedness, as well instruments such as purchased call options that convey only "upside" leverage because they do not impose a payment obligation that can potentially exceed the initial investment.

As the Commission observes, Congress' key concerns underlying the limitations in Section 18 include "excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities" and "funds operating without adequate assets and reserves." In order to address these concerns, the Commission has required to funds that invest in derivatives to set aside ("segregate") other liquid assets against the derivative to mitigate the derivative's "leverage".

Because the Commission has historically viewed derivatives as transactions that involve (increase) leverage in fund portfolios, the Commission has treated investing in derivatives by a managed investment company analogous to the issuance of a "senior security" subject to Section 18. We believe, however, that the Commission's definition of "leverage" articulated in Release 10666 is overbroad. The Commission's definition encompasses legitimate investment strategies that do not involve the potential for indebtedness, such as the purchase of call options. While these strategies involve risks that should be adequately disclosed to fund shareholders, it is not evident that the purposes of Section 18 are furthered by requiring segregation of assets against such transactions. Because there is no apparent need to segregate against transactions that convey only "upside" leverage, we believe it would be more appropriate to use segregation solely to ensure that funds have adequate resources to meet potential future obligations.

Segregation has proven to be an effective means of ensuring that funds have adequate resources to meet potential future obligations, however. Existing Commission and staff guidance permits two types of segregation – "notional" and "mark-to-market." In a no-action letter to Dreyfus[4] which addressed futures, forwards, options, and short sales, the Commission staff permitted a fund to cover these transactions by segregating the "notional" amount or full value of the potential obligation of the fund under the contract. More recently, informal disclosure positions taken by the Commission staff have permitted some funds to disclose in their prospectuses that, for certain cash-settled long positions in futures and forwards, rather than the notional amount, the fund will segregate assets equal to the fund's daily marked-to-market obligation (i.e., the daily difference between the fund's obligation to its counterparty and the counterparty's obligation to the fund).

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[3] Release at 13.

[4] Dreyfus Strategic Investing & Dreyfus Strategic Income (June 22, 1987).

BlackRock does not believe either methodology is an appropriate means of establishing the segregation requirement for every derivative transaction. "Notional" is an appropriate segregation amount in circumstances where a derivative is effectively substituting for one or more "long" physical security positions. In such cases, the full notional amount of the reference asset is at risk to the same extent as the principal amount of a physical holding, and any difference between the amount invested by the fund and the notional amount of the derivative is equivalent to a "borrowing". For example, a fund's purchase of an equity total return swap[5] produces an exposure and economic return substantially equal to the exposure and economic return a fund could achieve by borrowing money from the counterparty in order to purchase the equities that are reference assets. Many other uses of derivatives, however, do not place the full notional amount of the reference asset at risk to the same extent as the principal amount of a physical holding, because the derivative is not being used to substitute for "long" physical security positions but to hedge or adjust existing portfolio exposures. A fund's purchase of an interest rate swap[6] to adjust the fund's duration[7] only exposes the fund to potential payments based on adverse movements in interest rate relationships, which under foreseeable circumstances are only a small percentage of the notional principal amount of the interest rate swap. A fund's sale of a currency forward to hedge the currency risk of other assets in its portfolio would similarly expose the fund only to adverse movements in the relevant currency relationships, which typically would be very small as a percentage of the notional value of the trade (and, if the position is a truly a hedge, would be substantially offset by gains in the value of the instruments being hedged). A fund that purchases a credit default swap[8] is not exposed to potential payment obligations beyond the periodic amounts it has agreed to pay, and is never potentially exposed to losses equal to the notional amount of the swap.[9]

When viewed in the context of an overall portfolio, a derivative holding may increase overall leverage,[10] decrease overall leverage[11] or have no effect on overall leverage.[12]

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[5] When a fund purchases a total return swap, it agrees with a counterparty that the fund will periodically pay a short-term interest rate-based amount and periodically receive (or pay) any appreciation (or depreciation) in the market value of an equity security or equity securities.

[6] In an interest rate swap, a fund agrees with a counterparty that the fund will periodically pay a short-term interest rate-based amount and periodically receive a fixed income rate based on a notional principal amount (or *vice versa*).

[7] Duration is a measure of the sensitivity of a fixed-income instrument or portfolio to changes in interest rates.

[8] When a fund purchases a credit default swap, it agrees with a counterparty that the fund will periodically pay a short-term interest rate-based amount and receive a payment equivalent to the losses on a credit instrument in circumstances where the instrument suffers a defined credit impairment.

[9] A fund that *sells* a credit default swap could potentially be exposed to losses equal to the notional amount of the swap. however.

[10] A long futures or total return swap position will typically increase leverage, because the fund typically would pay only a small percentage of the notional amount as initial margin but is exposed to fluctuations in value of the full notional amount.

[11] A fund that has leveraged through borrowing in a foreign currency may reduce its exposure by purchasing that currency forward to match its payment obligations.

[12] An interest rate swap position will typically modify a fund's payment obligations and/or amounts it expects to receive on other holdings to a different form of payment but, at the time of the trade, has an equal chance of increasing or decreasing a fund's overall exposure or return.

Establishing an amount of liquid assets that must be segregated by adding up the aggregate potential exposures incurred through individual derivatives while ignoring other instruments in the portfolio and the derivatives' effect on overall portfolio risk does not seem to be the most accurate means of ascertaining an overall level of portfolio leverage. Instead, BlackRock supports a principles-based approach to segregation that would identify a reasonable amount for a fund to set aside against potential future obligations based on a risk measure.[13]

Any set of mechanical rules cannot take account of the diversity of derivatives and the multiplicity of ways they may be used by portfolio managers. Under a principals-based approach, the amount that would need to be segregated is the net payment amount to which the fund is potentially exposed under plausible scenarios, plus a risk premium. The method for determining the exposure would be established under policies adopted by fund boards and monitored by fund chief compliance officers ("CCOs"). Such policies should take into account factors such as the type of fund, the types of derivatives utilized, the manner in which derivatives are employed by portfolio managers, whether the fund receives from or is required to provide collateral to the counterparty, the compliance and risk management procedures in place to oversee the fund's use of derivatives and other factors. We believe that fund boards, with the assistance of counsel and the funds' CCO, have the skills necessary to approve and oversee the implementation of such policies.[14]

Consistent with this principles-based approach, we support the continued use of any liquid security for asset segregation purposes (as articulated in a no-action letter issued to Merrill Lynch Asset Management).[15] Holding cash and U.S. Government securities to satisfy asset coverage requirements may be in conflict with the stated investment objectives of a fund and effectively would prevent many equity and certain bond funds from being able to use derivatives when derivatives are the most effective ways of implementing portfolio strategies. This would limit the fund industry's ability to offer funds that provide the variety of risk and return profiles sought by investors.

Diversification

Section 5(b) of the Act provides that a fund meet certain requirements in order to be marketed to the public as "diversified," failing which, a fund would fall under Section 5(b)(2) of the Act and be categorized as a non-diversified fund (collectively, the "Diversification Rules").[16]

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[13] The use of common risk management measures such as value at risk ("VAR") may merit further consideration (although we do not specifically endorse any of the approaches to measuring leverage or risk taken by non-US regulatory regimes described in the Release).

[14] The boards responsible for the registered investment companies advised by BlackRock include nationally-recognized academic authorities on finance and portfolio risk.

[15] Merrill Lynch Asset Management L.P. (July 2, 1996).

[16] A diversified fund: "[a]t least 75 per centum of the value of its total assets is represented by cash and cash items (including receivables), Government securities, securities of other investment companies, and other securities for the purposes of this calculation is limited in respect of any one issuer to an amount not greater in value that 5 per centum of the value of the total assets and to not more than 10 per centum of the outstanding voting securities of such issuer".

Section 8(b)(1)(A) of the Act generally requires that a fund disclose in its registration statement its policy concerning the diversification of its assets. In addition, Section 8(b)(1)(E) of the Act generally requires that a fund disclose in its registration statement its policy concerning investment concentration. Specifically, Instruction 4 of Item 9 of Form N-1A requires a fund to disclose "any policy to concentrate in securities of issuers in a particular industry or group of industries" (i.e., investing more than 25% of a fund's net assets in a particular industry or group of industries) ("Concentration Rules")).

Application of the Diversification Rules and Concentration Rules to funds that hold derivatives is not straightforward. Derivatives are frequently bilateral contracts between the fund and another party – typically a financial intermediary in the case of over-the-counter derivatives (such as swaps or currency forwards) or an exchange clearing organization in the case of exchange-traded derivatives (such as futures). The other party is obligated to pay any amounts due to a fund and, therefore, the counterparty could technically be viewed as the "issuer" of the fund's obligation. The obligation to pay, however, is based on the value of an underlying reference asset, and it is the value of the reference asset to which a fund is primarily exposed through a derivative. Treating a derivative counterparty as an "issuer" for purposes of the Diversification Rules could lead to perverse results. For example, a diversified fund could be required to limit its exposure to exchange clearing organizations if such entities are treated as the "issuers" of derivatives, which could discourage the adoption of exchange-traded derivatives by funds. We believe it would be consistent with the purposes of these rules, and more accurately reflect a fund's true economic exposure, to treat the underlying reference asset of a derivative as the "issuer" of the derivative.[17]

Should the Commission agree that the Diversification Rules be interpreted to apply to the underlying reference assets, it logically follows that the Concentration Rules be interpreted in a consistent manner. The purpose of the Concentration Rules is to clearly identify for shareholders whether their investment is unduly exposed to a particular industry. For example, a retail shareholder would not expect a Large Cap Equity Fund to hold in excess of 25% of the fund's assets in the railroad industry absent a disclosed policy in the mutual fund prospectus. Similarly, if a Large Cap Equity Fund were to implement a trading strategy through total return swaps, it would be appropriate to look through the contract to the underlying reference assets to understand the risks to which the fund is exposed, rather than, suggesting that the exposure is to the financial intermediaries. Funds that use derivatives as principal investment strategies are already required to disclose that fact and discuss any associated risks, including counterparty risks. We believe it would confuse shareholders, without furthering the purpose of the rule, if funds that are substantial users of derivatives were required to disclose a policy of concentrating in investments in financial intermediaries or exchange clearing organizations.

Similar confusion may exist regarding the appropriate naming convention for mutual funds employing derivatives as a primary investment strategy. Section 35(d) of the Act generally makes it unlawful for any registered investment company to adopt as part of the name or title of

[17] This is consistent with current fund industry practice in respect of physical U.S. equities, which are held through The Depository Trust Company (DTC) as nominee. It is our understanding that any exposure to DTC or similar equity clearing organizations is generally disregarded for purposes of funds' compliance with these rules.

the company, or of any securities of which it is issuer, any word or words that the Commission finds are materially deceptive or misleading. Rule 35d-1 was adopted by the Commission to effectuate the prohibitions of Section 35(d). Rule 35d-1 generally requires a registered investment company to adopt a policy to invest at least 80% of its assets (including any borrowings for investment purposes) in the securities suggested by the company's name (collectively, the "Names Rule"). Certain funds hold portfolios consisting primarily of cash equivalents or short-term bonds overlayed with derivatives that provide exposure to equities, currencies or commodities.[18] Such funds may have in excess of 20% of its assets in short-term obligations, notwithstanding economic exposure to the underlying reference assets.[19] It is unlikely that it was intended, or that it would further the purposes of the Names Rule, for such a fund to disregard its economic exposure to the reference assets and suggest in its name that its focus is on short-term investments. We therefore suggest that the Commission clarify that actual economic exposure through reference assets should be used for purposes of determining compliance with the Names Rule.[20]

Custody

Section 17(f) of the Act generally requires that a fund place and maintain its securities and similar instruments only with certain qualified custodians. Rule 17f-6 was adopted by the Commission in order to permit a fund to place and maintain assets with a futures commission merchant ("FCM") that is registered under the Commodities and Exchange Act ("CEA") in amounts necessary to effect the fund's transactions on exchange-traded futures contracts and commodity options (collectively, "Custody Rules").

The Dodd-Frank Act requires, among other things, that the Commission and the Commodity Futures Trading Commission ("CFTC") adopt rules to facilitate the centralized clearing of certain derivative transactions that currently settle over-the-counter. It is expected, that forthcoming guidance from the Commission and CFTC will change how market participants execute and clear such transactions, including but not limited to, posting of initial margin with the derivative clearing organizations, rather than the counterparty.

The Custody Rules currently would not permit funds to provide and maintain margin with clearing organizations, other than in respect of futures margin. The Commission has recognized the need to address the fact that current Custody Rules would discourage funds from entering into centrally cleared derivative transactions, and the Commission staff has issued a

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[18] Such strategies are adopted by funds that seek to invest in certain non-U.S. markets which have restrictions or limitations on direct investments, or may present operational challenges to direct investments, that make gaining exposure to securities that trade primarily in such markets through a total return swap a beneficial alternative to direct investment; or that seek exposure to physical commodities, which are impractical for funds to invest in directly due to requirements applicable to funds under the Internal Revenue Code.

[19] Only the mark-to-market gain or loss from most types of derivatives is included as an asset or liability on a fund's financial statements.

[20] The Commission has previously stated that in appropriate circumstances, the fund could "include a synthetic instrument in the 80% basket if it has economic characteristics similar to the securities in the basket", but it is not clear if this is the current view of the Commission's staff. See Investment Company Names, Investment Company Act Release No. 24828 (Jan. 17, 2001).

series of No-Action letters to certain derivative clearing organizations that would permit a fund to provide and post margin to such clearing organizations in respect of interest rate and credit default swaps, subject to certain conditions.[21] The No-Action relief provided by the staff is temporary, however. We recognize that the Commission may wish to finalize the rules relating to centralized clearing of derivatives before establishing a final, permanent solution that would permit funds to provide and maintain margin with clearing organizations. We think it is important that the Commission act to do so at the earliest possible opportunity, however, in order to not to disrupt the trading of applicable derivative transactions by funds and to ensure that the provisions of the Dodd-Frank Act seeking to encourage central clearing of derivatives will apply in a consistent manner to funds. Given that funds are significant users of many of the affected derivatives, failure to update the Commission's requirements under Section 17(f) of the Act to permit funds to participate in new types of centrally-cleared derivatives created through the Commission's rulemaking under the Dodd-Frank Act could both be disruptive to funds and inhibit the adoption of such centrally-cleared derivatives by markets.

Exchange-Traded Funds

In a March 2010 press release, the Commission announced that the staff was evaluating the use of derivatives by investment companies, including registered ETFs. The press release indicated that pending completion of this review, the staff would defer consideration of exemptive requests under the Act relating to ETFs that would make significant investments in derivatives.[22]

Registered ETFs are only able to operate pursuant to exemptions from the Act (and certain other Commission regulations) obtained from the Commission. The conditions of exemptive orders relating to ETFs' use of derivatives has been inconsistent. Under current Commission exemptive relief, most ETFs that track an index on an unleveraged basis are permitted to use derivatives subject to a cap of 20% on non-index constituents (including derivatives). In contrast, ETFs that track an index on a leveraged or inverse basis are permitted to use derivatives without being subject to a cap, while most ETFs that do not track an index (but not those operating pursuant to exemptive orders granted prior to the moratorium) are prohibited from using <u>any</u> futures, options or swaps.[23]

BlackRock is not aware of any issues arising from the use of derivatives by unleveraged index-tracking ETFs that would give rise to a need for a moratorium on exemptions for such

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[21] <u>LCH Clearnet Limited</u> (July 29, 2011); <u>Chicago Mercantile Exchange</u> (July 29, 2011); <u>Chicago Mercantile Exchange – II</u> (July 29, 2011); <u>ICE Clear Credit LLC</u> (July 29, 2011).

[22] *See* SEC Press Release 2010-45, *SEC Staff Evaluating the Use of Derivatives by Funds* (Mar. 25, 2010) ("2010 Derivatives Press Release").

[23] While neither the Commission nor the staff have articulated a reason that ETFs that do not track an index should not be permitted to use derivatives that may be used by other funds, our understanding is that the Commission has concerns regarding leveraged and inverse funds' use of derivatives that led to the prohibition on ETFs that do not track an index from using derivatives (to ensure, among other things, that such ETFs would not engage in extensive use of leveraged swaps or inverse swaps to construct portfolios that resemble leverage or inverse ETF portfolios).

products. To the contrary, we believe that some use of derivatives is appropriate and useful to equitize cash or provide exposure to certain markets where there may be cost or access issues with physical holdings. Such use of derivatives is common in mutual funds that seek to track indices. We believe these investment techniques can benefit ETFs and ETF investors as well. BlackRock is an experienced manager of ETFs and does not believe there is anything about the ETF structure or manner of operating that makes such derivative transactions less attractive in ETFs than in mutual funds. Accordingly, we see no reason why unleveraged index-tracking ETFs should be treated any differently than other types of investment companies.

Likewise, we do not see a reason that ETFs that do not track an index should be prohibited from using derivatives in ways that are appropriate for their underlying strategies, disclosed to investors and commonly used by open-ended mutual funds that follow similar strategies. If there is concern with ETFs that do not track an index seeking to employ highly derivative-based strategies similar to leveraged and inverse ETFs, we believe the Commission could address this through other means, such as a cap on use of derivatives similar to the effective 20% limit applicable under existing index-based ETF exemptive relief. A complete ban on the use of derivatives by ETFs, however, does not appear justified by any facts of which we are aware.

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We thank the Commission for providing BlackRock the opportunity to comment on the Release, and we would be pleased to assist the Commission in any way we can to ensure that the Commission's consideration of the issues raised in the Release will most benefit investors in managed investment companies. In the event you have any questions about any of BlackRock's views, please feel free to contact the undersigned.

Sincerely,

Joanne Medero/ips

Joanne Medero
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BlackRock, Inc.

I Shapiro

Ira Shapiro
Managing Director, Law and Compliance
BlackRock, Inc.

cc: The Honorable Mary L. Schapiro
The Honorable Elisse B. Walter
The Honorable Luis A. Aguilar
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