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November 11, 2011

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
Attention: Elizabeth M. Murphy, Secretary

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

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee" or "we") of the Business Law Section of the American Bar Association (the "ABA"). This letter is in response to the request by the Securities and Exchange Commission (the "Commission") for comments regarding the use of derivatives by investment companies in the release referenced above (the "Concept Release").[1] This letter has been prepared with the significant participation of the Committee's Task Force on Investment Company Use of Derivatives and Leverage. The comments expressed in this letter represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA.

At the 2009 Spring Meeting of the Business Law Section of the ABA in Vancouver, Andrew J. Donohue, former Director of the Commission's Division of Investment Management (the "Division"), requested that the Committee's Subcommittee on Investment Companies and Investment Advisers address concerns about investment company use of derivatives and leverage. In response, the Task Force was created to study current industry practices in the context of existing laws and regulatory interpretations. We evaluated whether the current regulatory scheme was adequate in view of current issues confronting the derivative markets, as they relate to investment companies.[2] On July 6, 2010, the Task Force presented its Report to the Division (the "Report").[3] The Report included suggested alternative approaches to dealing

1 *See* Use of Derivatives by Investment Companies under the Investment Company Act of 1940, SEC Release No. IC-29766 (Aug. 31, 2011) (the "Concept Release").

2 The Task Force consists of leading investment company lawyers who are members of the Subcommittee on Investment Companies and Investment Advisers.

3 *See* Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law (July 6, 2010). The Report is available at http://meetings.abanet.org/webupload/commupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf

with the complicated set of legal issues that are presented by the use of derivatives by investment companies.

As a general matter, the Task Force continues to support the discussion and recommendations that it set out in the Report. Since July 2010, we have not observed developments that have affected our key recommendations that are set forth at the beginning of the Report. Likewise, there have been no significant developments that have affected Part IV of the Report, which discusses the proposed process for implementation of the recommended changes to regulatory oversight or guidance.

The Task Force commends and supports the Commission's comprehensive undertaking to review and consider the use of derivatives by investment companies. Set forth below are references to certain specific matters highlighted in the Report which we believe are responsive to inquiries in the Concept Release, as well as additional comments from the Task Force.

Fund Director Oversight

1. The Report recommended that the Commission or its staff emphasize that the role of the fund board with respect to a fund's use of derivatives and leverage is one of oversight, rather than micromanagement. In addition, the Report recommended that the Commission or its staff consider proposing guidance for public comment on the proper role of fund directors in overseeing derivatives and leverage. While the Concept Release notes that the Commission's staff has been exploring issues such as "whether funds' boards of directors are providing appropriate oversight of the use of derivatives by the funds," the Concept Release does not discuss what constitutes the appropriate level of oversight by a fund board. We therefore reiterate our initial recommendation. We also separately note that, from our collective experience, a number of fund directors have indicated that they would welcome guidance confirming the scope of their oversight (rather than micromanagement) role in this area.

Section 18 Issues – Limits on Leverage

2. The Task Force reiterates that the broad approach taken by the Commission in Release IC-10666[4] for regulating leverage is effective and continues to provide an appropriate framework for funds' use of derivative instruments that entail leverage. This approach for regulating leverage focuses on indebtedness leverage. For those transactions that possess, in contrast, only economic leverage, which concern the risks and volatility of a fund (similar to that of other types of non-derivative investments), the Task Force continues to believe that such transactions should be regulated only through disclosure to ensure consistency with the fund's disclosed investment practices and risk factors.

3. The Report recommended that the Commission or its staff require funds to develop and maintain "Risk-Adjusted Segregated Amounts" ("RAS Amounts"). A fund would establish a minimum amount of required segregated assets based on the risk profile of the derivative

[4] *See* Securities Trading Practices of Registered Investment Companies, SEC Release IC-10666 (Apr. 18, 1979).

instrument and a fund's portfolio. If the Commission endorses the RAS Amounts approach, Value at Risk or other methodologies for assessing the probability of portfolio losses may be useful tools in determining the amount of assets for segregation purposes. However, the Task Force believes that these methodologies, while useful tools, should not be used as a substitute for the framework established by Release 10666. RAS Amounts are designed to address the practical concerns of the difficulty in determining a set of formulaic asset segregation requirements on a derivative instrument-by-derivative instrument basis.

4. The Commission requested comment on the regulatory approach to leverage taken in the CESR Global Exposure Guidelines ("CESR Guidelines"). The Task Force notes that the "commitment" method under the CESR Guidelines involves a detailed schedule published by regulators setting forth conversion methods to be used in calculating global exposure for each type of derivative instrument. The Task Force continues to believe that such a detailed list would not be a workable solution in the U.S. regulatory context, for the reasons set forth in the Report, and that the RAS Amounts approach builds upon the strengths of the existing regulatory framework under the Investment Company Act of 1940, as amended (the "Investment Company Act"), in a way that the commitment approach would not. The Task Force also notes that the advanced risk management method permitted under the CESR Guidelines allows at least as much discretion as would the RAS Amounts approach without the limitations on exposure imposed by the asset segregation approach under which the RAS Amounts approach would operate.

5. The Report recommended that policies and procedures governing asset segregation should cover not only the value of segregated assets, but also the types of such assets. Assets, other than cash items and very liquid, high quality securities, should be subject to a "haircut." Additional haircuts should be required if the segregated assets are closely correlated with the exposure created by the derivative.

6. The Commission asked whether it should revise its position in Release IC-10666 to provide expressly for cover methods in addition to asset segregation and, in the event it takes such action, whether it should take the position that a fund may only enter into such non-asset segregation cover methods with the same counterparty to the senior security being covered. The Task Force agrees that the Commission should expressly provide for cover methods in addition to asset segregation and is of the view that funds should not be limited to transactions with the same counterparty in arranging non-asset segregation cover, but instead should have the flexibility to arrange such alternative cover with counterparties of their choosing. The Task Force is of the view that the only consideration should be whether or not a fund's obligation is appropriately covered.

7. The Commission requested comment as to whether the 300% asset coverage standard for bank borrowing should also be used for the treatment of other senior securities transactions (*i.e.*, 100% asset coverage). The Task Force does not believe this approach is necessary or appropriate given the differences between bank borrowing and the use of derivatives. First, as previously indicated, the Task Force believes that the existing framework as set forth under Release IC-10666 has worked well. Second, bank borrowing involves a fund being extended

credit (*i.e.*, economically identical to issuing debt/senior securities) as opposed to a senior securities transaction where an initial investment has only the potential to result in a future liability. Third, the asset segregation requirement for senior securities mandates that initial and additional assets must be set aside in order to meet a future liability which in many cases will be contingent. The Task Force, therefore, does not believe that changing the framework as set forth under Release 10666 is necessary or advisable.

Section 5(b) and Diversification and Section 8(b)(1) Concentration Limits

8. The Report recommended that reference assets that do not lend themselves to the concept of concentration and diversification, such as broad-based stock index futures and other broad-based indices as defined in the Securities Exchange Act of 1934 or the rules thereunder, commodity index-linked futures, and treasury futures, should be excluded from the concentration and diversification requirements. To the extent that the Commission has not addressed this matter in the Concept Release, we reiterate our prior recommendation.

Section 12(d)(3): Securities-Related Business Considerations

9. The Task Force continues to believe that Section 12(d)(3) of the Investment Company Act provides an appropriate framework for dealing with fund counterparty exposures. The Report recommended that that in applying Section 12(d)(3) to limit counterparty exposure, the Commission acknowledge a fund's derivative positions that are collateralized. In our experience, many fund groups have entered into arrangements with counterparty banks that establish bankruptcy-remote collateral arrangements whereby the bank posts both initial margin (an independent amount) as well as additional collateral designed to cover the bank's obligations to the fund, marked to market daily. The Commission should factor in such arrangements as it considers limits on counterparty exposure because such arrangements do not pose the same risks as similar relationships that are uncollateralized.

Disclosure

10. The Report recommended that the Commission or its staff provide guidance that funds, when measuring compliance with their disclosed investment objectives and policies, should look through to a derivative's reference assets (or the nature of the economic exposure, when applicable), rather than to the issuer. To the extent that the Commission has not addressed this matter in the Concept Release, we reiterate our prior recommendation, particularly when the fund has substantial actual exposure to the reference assets. We note that this may not always be the case.

11. The Report recommended that funds enhance disclosure of how derivative instruments affect actual investment results. While the Concept Release notes that the Commission's staff is exploring issues such as "whether existing prospectus disclosures adequately address the particular risks created by derivatives," we encourage the staff to consider the disclosure recommendations that are set forth in the Report.

Roundtable

12. The Report recommended that that Commission or its staff consider additional means to develop insight into current practices of fund use of derivatives and leverage and the appropriate level of regulatory oversight. We reiterate our initial recommendation to convene, for example, a Commission roundtable that would give the Commission or its staff the opportunity to learn how portfolio managers, traders, operations personnel and compliance officers manage the risk of derivatives and leverage.

The members of the Committee and the Task Force would be pleased to discuss with you or your staff any of the issues referred to in the Report or in the Concept Release.

Sincerely,

/c/ Jeffrey W. Rubin
Jeffrey W. Rubin, Chair of the Federal
Regulation of Securities Committee

/c/ Jay G. Baris
Jay G. Baris, Chair of the Task Force on Investment Company Use
of Derivatives and Leverage

cc: Members of the Task Force
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