Re: File No. S7-33-11

November 11, 2011

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

Dear Ms. Murphy:

We are writing in response to the request by the Securities and Exchange Commission (the “Commission”) for comments regarding Investment Company Act Release No. 29776, Use of Derivatives by Investment Companies Under the Investment Company Act of 1940 (the “Release”).1 We recognize and strongly support the ongoing efforts of the Commission and its staff (the “Staff”) to provide guidance regarding the use of derivatives by investment companies registered with the Commission under the Investment Company Act of 1940 (as amended, the “Investment Company Act” or the “Act”), and the Commission’s efforts toward a more comprehensive and systematic approach to derivatives-related issues under the Act. We appreciate the opportunity to comment on the issues raised in the Release.2

As the Release indicates, the Commission and the Staff, over the years, have addressed issues pertaining to the use of derivatives transactions by registered funds on an intermittent case-by-case basis.3 While this guidance has been helpful, it has not been able to keep pace with the dramatic expansion of the derivatives market over the past twenty years, both in terms of the types of instruments that are available and the extent to which funds use them. The guidance has therefore been increasingly difficult to apply to particular derivatives transactions. In some cases, the regulatory uncertainty may lead a fund to select one type of instrument or transaction over another for non-investment reasons, or to avoid certain instruments or transactions altogether. This can lead to inefficiencies that are detrimental to funds and their shareholders. In addition, funds and their sponsors may interpret the available guidance differently, even when applying it to the same instruments, which may unfairly disadvantage

2 The opinions expressed herein represent those of the undersigned and not necessarily those of our clients.
3 Release, supra note 1, at 55239.
some funds. Incomplete or ambiguous guidance also complicates discussions with derivative dealers, who often face substantial uncertainty in navigating the regulatory landscape faced by their registered fund clients. Despite these uncertainties, however, registered funds continue to use, and expand their use of, a wide array of derivative instruments.

Section 18 and “senior securities”

Section 18(f)(1) of the Investment Company Act prohibits an open-end fund from issuing “senior securities,” except that an open-end fund may borrow money from a bank, provided that the aggregate amount of its assets (less all liabilities and indebtedness not represented by senior securities) is at least 300% of the aggregate amount of outstanding borrowings. A “senior security” is defined in Section 18(g) as “any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness.” Closed-end funds are somewhat less restricted than open-end funds; a closed-end fund is permitted by Section 18(a) to issue a "class of senior security that represents indebtedness," but only if immediately after such issuance, it will have asset coverage of at least 300%.

Segregation Requirements

In Release 10666, the Commission stated that reverse repurchase agreements, firm commitment agreements and standby commitment agreements, as well as similar trading practices, “fall within the legislative purposes of Section 18” because they involve “speculative purposes” or “accomplish leveraging.” More specifically, according to the Commission, such instruments or trading practices could be viewed as “evidencing indebtedness,” and therefore be included in the Section 18 prohibitions against issuing senior securities. However, the Commission indicated in Release 10666 that the Staff would not raise compliance with Section 18 as an issue, so long as a fund “covered” its obligation by maintaining a segregated account containing liquid assets at least equal to the potential obligation of the fund in connection with the

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4 Concerns about equal treatment have also been raised by the Staff’s decision to defer consideration of exemptive order requests under the Act that permit exchange-traded funds (“ETFs”) to make significant investments in derivatives. See SEC Press Release 2010-45, SEC Staff Evaluating the Use of Derivatives by Funds (Mar. 25, 2010) available at http://www.sec.gov/news/press/2010/2010-45.htm. While we appreciate the Staff’s interest in thoroughly reviewing the use of derivatives by ETFs to ensure continued protection of investors in derivative-based ETFs, we share the concerns of industry participants who believe that, in denying new exemptive orders for derivative-based ETFs while permitting ETF sponsors with existing orders to continue to launch such products, an unequal playing field has been created. See Jackie Noblett, SEC not budging on ETF derivatives ban, Fin. Times, Sept. 8, 2011, http://www.ft.com/intl/cms/s/0/a7334846-da11-11e0-b199-00144feabdc0.html.


6 Investment Company Act § 18(g).


transaction.\textsuperscript{9} In subsequent no-action letters, the Staff indicated that segregation would not be required to the extent a fund “covers” a transaction in an approved manner by using offsetting instruments or positions.\textsuperscript{10} Later guidance also indicated that a fund may use an offsetting instrument or position to partially cover its exposure under a transaction, and segregate assets to cover any residual exposure.\textsuperscript{11}

In Release 10666 and in no-action letters, the Commission and the Staff generally indicated that funds relying on the segregation method should segregate assets equal to the full notional value of the reference asset for a derivative (the “\textbf{notional amount}”), less any collateral or margin on deposit. However, the notional amount of a derivative is often not the relevant measure of the fund’s obligations. Over time, the Staff has accepted policies adopted by funds that contemplate segregation of the mark-to-market value rather than the notional amount for certain instruments. For example, fund registration statements indicate that, in recent years, the Staff has not objected to the adoption by funds of policies that require segregation of the mark-to-market value, rather than the notional amount, for a variety of swaps\textsuperscript{12} as well as for cash-settled futures and forward contracts.\textsuperscript{13}

The current approach to segregation leaves many open questions and may lead to inconsistent results for financially similar instruments. For example, the Staff has permitted segregation of the mark-to-market value for cash-settled futures contracts, but continues to require segregation of the notional amount for contracts that may settle physically. Thus, for example, a fund that invests in a cash-settled futures contract on a commodity index, such as Continuous Commodity Index Futures on the ICE Futures Exchange, or S&P GSCI Futures or Dow-Jones-UBS Commodity Index Futures on the CME, would only be required to segregate the mark-to-market value of the contract, while a fund that invests directly in the physically-settled futures contracts comprised by the index would be required to segregate the \textit{notional value} for each contract. Although many commodity futures can be traded only through physically-settled contracts, very few funds use these instruments at all, because the requirement to segregate the notional amount makes doing so impracticable. Instead, funds enter into over-the-counter swaps that provide similar economic exposure, even though swaps tend to be more expensive and present other potential risks, such as counterparty risk and lack of liquidity.

\textsuperscript{9} In the \textit{Dreyfus} no-action letter, the Staff explicitly extended this approach to long and short positions in futures and forward contracts, and written put and call options. Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC Staff No-Action Letter (June 22, 1987) (“\textit{Dreyfus Letter}”), available at \texttt{http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm}.


\textsuperscript{11} Hutton Options Letter, \textit{supra} note 10.

\textsuperscript{12} According to the ABA Report, in 1989 the Staff began permitting funds to disclose in registration statements that they would cover the mark-to-market value, rather than the notional amount, for interest rate swaps. The 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 “\textit{ABA Report}”) n. 22, \texttt{available at http://meetings.abanet.org/webupload/commpupload/CL410061/sitesofinterest_files/DerivativesTF_July_6_2010_final.pdf} (\textit{citing} Eaton Vance Prime Rate Reserve, Registration Statement for Closed-End Investment Companies (Form N-2) (July 13, 1989)). It appears from registration statements that many funds now use this approach for a much wider array of swaps.

\textsuperscript{13} ABA Report, \textit{supra} note 12 at 14-5.
An analysis of the mechanics of physically-settled contracts, however, shows that the notional amount of a contract, by itself, does not necessarily capture, and may greatly overstate a fund’s exposure under such an instrument. The notional value of a futures contract is equal to the number of units represented by the contract multiplied by the price per unit (e.g., for corn futures, 5000 bushels per contract times $5 per bushel, for a notional value of $25,000 per contract). The market value of a futures contract on any day is equal to the gains or losses on the contract (e.g., if the price of corn increases by 10 cents, the market value of the position for a buyer of the contract in the foregoing example would increase by $500, or 5000 times 0.10, while the market value for the seller of the contract would decrease by the same amount). Variation margin payments equal to the mark-to-market gains or losses on the contract are made to or from the account of a holder daily through the clearinghouse; the holder of a position receives variation margin if the value of the contract moves in favor of the holder, and pays margin if the value of the contract moves against it. In effect, the daily marking to market forces a position holder to recognize its gains or losses on a contract each day, thus making it very unlikely that a fund would ever be suddenly faced with a payment obligation comparable to the notional amount of a physically-settled contract.

Further, notwithstanding the terms applicable to physically-settled contracts, the vast majority of market participants do not settle contracts by delivery. Rather, contracts are closed out through the process of offset, whereby the holder of the position (i.e., the fund) enters into an offsetting position prior to expiration. The amount payable in an offsetting transaction will be much more akin to a variation margin payment than to the notional value of the contract. Moreover, even if a fund holds a physically-settled contract until expiration, it will never directly face a physical delivery obligation unless it affirmatively opts to do so. This is because under futures exchange and clearinghouse rules, the obligation to make or take delivery of the commodity or other instrument underlying a physically-settled contract belongs to a clearing member, not to its customer. In addition, the customer of a futures commission merchant (“FCM”) generally has a contractual right to instruct the FCM (which will itself be a clearing member, or the customer of a clearing member) on how to settle the customer’s positions, and is only liable to the FCM for the net amount upon settlement. Thus, for example, the FCM could hold a short futures position for its customer until expiration, at which point the customer may instruct the FCM to purchase the underlying commodity in the cash market in order to make delivery. Because delivery contracts always provide for delivery-against-payment, the FCM will receive cash upon delivering the commodity, and the contractual obligation of the customer (i.e., the fund) to the FCM will be, at most, the difference between the contract settlement price, on the one hand, and amount the FCM paid for the commodity that it delivered (plus any fees and expenses), on the other hand. Similarly, if the FCM holds a long position for its customer until expiration, the FCM may need to take delivery of a commodity, which the customer can instruct the FCM to sell in the cash market. In that case, the contractual obligation of the customer (i.e., the fund) to the FCM will be, at most, the difference between the contract settlement price, on the one hand, and the amount the FCM received for the commodity in the cash market (less any fees and expenses), on the other hand.

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14 The Release notes that for many futures contracts, “the notional amount may, as a practical matter, exceed the maximum loss or total risk on the contract.” Release, supra note 1 at 55244.

15 See, e.g., CME Rulebook, Rule 702 available at http://www.cmegroup.com/rulebook/CME/I/7/02.html. (“A clearing member carrying an account that is required to make or accept delivery, agrees to guarantee and assume complete responsibility for the performance of all delivery requirements set forth in the [CME] rules.”)
The foregoing makes clear that a fund is unlikely to face an obligation under a physically-settled futures contract that is meaningfully correlated to the notional value of the contract. Instead, the fund’s payment obligations are determined by daily mark-to-market changes in the value of the futures contract, and therefore the current approach of setting a fund’s segregation obligation by reference to the notional contract amount does not appropriately reflect the risk posed by such instruments.

**Risk-Based Framework**

The differences in segregation requirements described above exemplify one of the deficiencies of the current binary, market value vs. notional amount standard for segregating assets, which is that the standard results in widely disparate treatment of economically similar instruments.

A more fundamental problem with the current approach toward derivatives, however, is that it essentially ignores altogether a variety of important factors relating to the risk of a particular derivative instrument. For example, the risk profile for a swap that a fund may terminate at any time without significant penalty is likely to be very different from the risk profile for an illiquid option written by the fund. Volatility will also affect the risk profile for a derivative. Under the current standards, however, liquidity and volatility are not required to be considered.

We note further that most derivatives are materially different from indebtedness obligations referenced under Section 18 because, unlike borrowings or other indebtedness, derivatives usually represent the incurrence of a contingent obligation, and the amount of the obligation may be negligible or substantial, depending usually on changes in market prices. In this regard, swaps and other derivatives are also very different from reverse repurchase transactions, which were among the earliest type of counterparty transactions that were addressed by the Commission under Section 18.

Rather than adopting further rules for the coverage of particular derivatives, we urge the Commission to develop a risk-based framework that would establish a general approach for the treatment of derivatives under Section 18. Creating such a framework would first require the Commission to work closely with industry groups to develop a consistent analytical approach to measuring risk resulting from investments in derivatives. The general framework could be based on “Risk Adjusted Segregated Amounts” (as proposed in the ABA Report), Value at Risk (VaR), or another type of metric that offers a framework for measuring risk.

Any approach should take into account both the magnitude of the risk incurred by a fund and the contingent nature of that risk. Requirements imposed on funds’ use of derivatives would need to take into account a variety of considerations, including the anticipated volatility of the derivative (whether due to the terms of the derivative, the economic leverage embedded in the derivative or the volatility of the underlying reference asset), the collateralization requirements applicable to the fund and to its counterparty, the term of the derivative, the liquidity of the derivative and of the underlying reference asset, the settlement terms for the derivative and whether the derivative is hedging actual cash investments made by a fund or is otherwise subject to offsetting transactions. The manner of balancing and implementing these considerations will require considerable technical guidance and input from industry participants.
We believe that the Commission should also work with the industry to develop a consistent format for appropriate prospectus disclosure regarding the level of derivatives exposure that may be incurred by a fund. It would be the responsibility of the funds’ advisers to manage their funds within the disclosed risk parameters, under the overall oversight of the board. The board’s responsibility would therefore be the same as it is today with respect to monitoring investment performance – the board would monitor the adviser’s derivative use and risk management, but would not be responsible for determining how to analyze the risk of specific instruments.

A framework such as described above could potentially remedy many of the deficiencies and inconsistencies that result from the current approach. In determining an appropriate framework, we urge the Commission to consider industry views. Any appropriate framework that is more nuanced than the current approach is likely to involve greater operational complexity, and therefore a greater commitment of resources from advisers, boards, and fund service providers. Such considerations must be balanced relative to the benefits of a framework.

By contrast, any prescriptive approach to regulating individual derivative instruments on a case-by-case basis is unlikely to be successful in addressing the wide array of derivative instruments, particularly new products that come to market, and the various ways that funds use those derivatives. For example, as the Staff has acknowledged, derivatives may both increase or reduce portfolio risk, and an instrument that decreases risk in one fund’s portfolio may have an opposite effect for another fund.

**Economic Leverage**

We believe that the Commission’s regulation of derivatives as “senior securities” should focus on derivatives that create indebtedness leverage, as opposed to economic leverage. Economic leverage is provided by instruments, such as purchased options, commodity-linked notes or certain equity-linked notes, that “provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations… such as changes in stock prices or interest rates” and therefore “magnify a fund's gain or loss from an investment.” In the report of the Division of Investment Management on mutual fund use of derivatives in 1994, the Staff stated that “[t]he Commission and the Division have not applied section 18 of the Investment Company Act to derivatives that create economic leverage.” While noting that the Division was concerned about the potential for increased volatility from economic leverage, the report advised against restricting the use of derivatives that provide economic leverage, citing several reasons:

First, a prohibition or restriction on derivatives use could chill the use of instruments in a manner that is beneficial for mutual funds, such as hedging. Second, a prohibition or

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17 Commodity-linked notes provide economic leverage because they provide a return based on the performance of a futures contract (or index of futures contracts), which are leveraged instruments. Unlike futures contracts, however, an investor’s exposure is limited to, at most, the purchase price of the note, which is paid by the investor up-front, so there is no indebtedness leverage. Equity-linked notes that offer a return linked to a multiple of the return of a reference security (or index of securities) similarly offer economic, but not indebtedness leverage.

restriction on derivatives use would be inconsistent with the general approach of the Investment Company Act, which imposes few substantive limits on mutual fund investments. Funds generally are permitted to make investments without regard to their volatility, e.g., emerging market securities and small company stocks, and we are not persuaded that derivatives should be treated differently. Third, it would be extremely difficult, if not impossible, to devise appropriate prohibitions or restrictions on the use of derivatives by mutual funds because of the wide variety of instruments that may be considered “derivatives.”

In our view, the foregoing considerations are as relevant today as they were in 1994. Moreover, we do not believe that Section 18 was intended to limit forms of leverage that do not involve indebtedness or the potential for future obligations. While the legislative history of the Act shows a concern that senior securities representing indebtedness could lead to unpredictable volatility, neither the legislative history nor the Act evince a congressional intent to regulate volatility as such. Rather, volatile investment strategies and investments can, in our view, be adequately regulated through appropriate disclosure requirements.

Section 12(d)(3)

Section 12(d)(3) of the Act prohibits a registered investment company from purchasing or otherwise acquiring “any security issued by or any other interest in the business of any person” who is a broker or a dealer, engaged in the business of underwriting, an investment adviser to a registered investment company, or an adviser registered under the Investment Advisers Act (each, a “securities-related issuer”). The Commission has indicated that the purposes behind Section 12(d)(3) are to limit (i) “a fund’s exposure to the entrepreneurial risks of securities-related issuers, including the fund’s potential inability to extricate itself from an illiquid investment in a securities-related issuer,” and (ii) the possibility of abusive reciprocal practices between funds and securities-related issuers.

Rule 12d3-1 provides a partial exemption from Section 12(d)(3), by permitting a fund to purchase, with few restrictions, “securities” of any issuer that derived less than 15% of its gross revenues from securities-related activities in its most recent fiscal year. The rule also permits a fund to purchase securities of an issuer that derived more than 15% of its gross revenues from securities-related activities in its most recent fiscal year, but subject to restrictions. In the derivatives context, the restriction in Rule 12d3-1 that is most often implicated is the prohibition on a fund investing more than 5% of the value of its total assets in the securities of such an issuer.

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21 See also Section 1(b)(7) of the Act, which states as policy that the interests of investors are adversely affected “when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities” (emphasis added). Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7) (2011).
23 Rule 12d3-1 does not permit a fund to purchase (a) a general partnership interest in an issuer; (b) a security issued by the fund's promoter, principal underwriter, or any affiliated person of such promoter or principal underwriter; or (c) a security issued by the fund's investment adviser or such investment adviser's affiliate, except, in certain circumstances, a security issued by a subadviser to the fund or a subadviser's affiliate. Investment Company Act Rule 12d3-1, 17 C.F.R. § 270.12d3-1 (2011).
We note the suggestion in the Release that derivatives that are not "securities" may not be eligible for the partial exemption from Section 12(d)(3) that is provided by Rule 12d3-1. We do not believe, however, that the prohibition in Section 12(d)(3) against the acquisition of any "interest in the business of" a securities-related issuer should apply to derivatives transactions between a fund and such an issuer. The history and text of Section 12(d)(3) strongly suggest that the focus of Section 12(d)(3) is capital investments by funds in securities-related issuers.24 The reference to an "interest in the business of" a securities-related issuer appears intended to cover general partnership interests.25 For this reason, we do not think that Section 12(d)(3) should be read to apply to derivative trades that represent an obligation of a securities-related issuer but do not provide a return based on the performance of the "business of" the issuer.26

Nevertheless, we agree with the view expressed in the ABA Report that Section 12(d)(3) may provide a framework for dealing with counterparty risk exposures for funds, and that the Commission should adopt a new rule to address counterparty risk. In developing such a rule, the Commission should work with industry groups to determine a consistent analytical approach to measuring counterparty exposure and establishing appropriate exposure limits.27 We believe, however, that a fund’s exposure to a counterparty under any such rule should be based on the mark-to-market exposure that the fund has to its counterparty. Because the purpose of the rule will be to appropriately limit the exposure of the fund to a counterparty’s credit risk, exposures across all derivative transactions between the fund and a counterparty should be netted, and should be deemed appropriately reduced by the value of any liquid collateral that is delivered to a collateral agent or custodian for the benefit of the fund as security for the obligations of the counterparty.

We also believe that the second statutory purpose of Section 12(d)(3), preventing reciprocal practices between funds and securities-related issuers, is unlikely to be implicated when a fund merely enters into a derivative instrument with a securities-related issuer as its counterparty. As noted above, we believe that Section 12(d)(3) primarily concerns ownership by funds of capital interests in securities-related issuers. If a fund owned a substantial equity investment in a securities-related issuer, then concern about reciprocal trading practices involving derivatives between the fund and the issuer might be more warranted. However, Rule 12d3-1 prohibits a fund from ever owning more than 5% of the equity of an issuer that derives more than 15% of its gross revenues from securities-related activities, which means in most cases the rule will already prohibit a fund from owning more than 5% of its counterparty.28


26 We also do not believe that it is appropriate to look to a fund’s counterparty in a derivative transaction in order to determine compliance with diversification or portfolio concentration requirements.


28 Even if the counterparty derived 15% or less of its gross revenues from securities-related activities, such that Rule 12d3-1 would not prohibit a fund from owning more than 5% of the counterparty’s equity securities, the risk of reciprocal trading practices involving derivatives would likely be prevented by Section 17(a) of the Act,
Issues Related to Dodd-Frank

The Commission and the Commodity Futures Trading Commission, along with other financial regulators, are currently involved in the process of finalizing and implementing regulations regarding the treatment of swaps, security-based swaps and other derivatives under Title VII of Dodd-Frank. We urge the Commission to take into account the final results of this rulemaking activity and the arrangements that are being implemented in connection with clearing and collateralization requirements for swaps transactions. These regulatory requirements will substantially alter, and are expected to reduce, certain risks related to derivative transactions. For example, mandatory clearing and exchange-trading of swaps and security-based swaps, and related requirements regarding collateralization of exposures for such instruments, will alter and can be expected to reduce many of the types of risks at which the regulation of derivative use by funds is directed, such as leverage, illiquidity and counterparty risk.

In addition, Dodd-Frank will require the Commission or the Staff to address other areas not covered in the Release. For example, new rulemaking (or no-action or exemptive relief) may be appropriate in order to adapt the requirements of Section 17 of the Act to trading practices of funds relating to swaps and securities-based swaps. Section 17(e) of the Act and Rule 17e-1 thereunder permit an affiliated person of a fund to act as the fund’s broker with respect to securities transactions, and to receive “usual and customary” remuneration therefor, as long as such remuneration is fair and reasonable compared to the remuneration received by other brokers in comparable transactions and certain procedural safeguards are met.\(^{29}\) Rule 17e-1 applies only to “securities,” as defined in Section 2(a)(36). However, the Staff has issued no-action letters that permit a fund to use affiliated brokers and FCMs for the execution of transactions in instruments that are not, or may not be, “securities,” such as futures contracts, options on futures contracts, and foreign currency contracts and options in the Interbank market, provided that the arrangements comply in substance with the requirements of Section 17(e) and Rule 17e-1.\(^{30}\)

The no-action letters relating to futures contracts and options on futures contracts referred to above require initial margin for such positions to be held at the fund’s third-party custodian (generally a bank) pursuant to a tri-party agreement among the fund, the custodian and the fund’s affiliated FCM, while any variation margin payments may be made directly from the fund to its FCM. Subsequent to the issuance of these no-action letters, the Commission adopted Rule 17f-6,\(^{31}\) which permits a fund to custody cash, securities, and similar investments, in amounts necessary to effect the fund’s transactions in futures contracts and options on futures contracts referred to above. Over-the-counter derivative transactions generally are principal trades, and if a fund owned more than 5% of the voting securities of its counterparty, or any person controlling or controlled by its counterparty, it would be an affiliate (or an affiliate of an affiliate) of the counterparty, and such trades would be prohibited.


contracts, with an unaffiliated FCM. The unaffiliated FCM, in turn, may transfer such assets to another FCM, or to a bank or clearing organization, as appropriate in order to effect the fund’s futures trades.

The mechanics of clearing swaps are similar to those for clearing futures and may become even more similar as the swap trading and clearing requirements of Dodd-Frank are implemented. Rule 17f-6, however, is limited to transactions by funds in “Exchange-Traded Futures Contracts and Commodity Options,” which, as defined in the rule, currently does not encompass cleared swaps. However, the Staff has issued no-action letters in 2010 and 2011 that permit funds to custody assets with clearing houses, clearing members and/or FCMs, subject to compliance in substance with the requirements of Rule 17f-6, in connection with credit default swaps and/or interest rate swaps cleared through the CME Group clearing house,32 ICE Trust33 and LCH.Clearnet.34 Because the requirements of these no-action letters track those of Rule 17f-6, the letters do not permit a fund to custody assets with an affiliated FCM or clearing member in connection with cleared CDS or interest rate swaps.

As a result of Dodd-Frank, standardized, liquid swaps are expected to become subject to clearing and exchange trading requirements. This will require funds to post initial and variation margin to an FCM, who in turn will post such assets with the clearing organization. We expect it will be appropriate for the Commission to amend Rule 17f-6 in order to codify the ability of funds to custody assets in a manner similar to that contemplated in the CME Group, ICE Trust and LCH.Clearnet no-action letters. In addition, as the market for cleared swaps develops, it may become cost-effective and appropriate for some funds to use the services of an affiliate to execute cleared swaps, and we urge the Commission and the Staff to consider additional no-action relief under Section 17(e) and Rule 17e-1, or consider amending Rule 17e-1 or creating a new rule, regarding appropriate procedures for the execution of swaps through affiliates. Such relief or rulemaking should include consideration of whether funds that execute swaps through affiliated FCMs or clearing members should also be permitted to custody assets with those affiliates.

**Exchange-Traded Funds**

The Release requests comment regarding whether ETFs use derivatives for the same purposes as other open-end funds, and whether the use of derivatives by ETFs raises unique

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investor protection concerns under the Investment Company Act. In our observation, ETFs use derivatives in ways that mirror the ways other types of investment companies use derivatives. For some ETFs (as is the case for some mutual funds), derivatives are the primary means by which the ETF obtains its investment exposure. For other ETFs, derivatives are used for more limited purposes, such as hedging currency exposure on a portfolio that tracks an international securities index or gaining access to a security that is difficult to acquire. We do not believe that ETFs are currently doing anything through the use of derivatives that other investment companies are not doing or would not be permitted to do. Moreover, the fact that ETFs are exchange-listed and required to continuously publish portfolio and valuation information may mean that their investors have better information about ETFs, including information about the use of derivatives, than investors in open-end funds that are not listed, or in closed-end funds that are listed but not required to provide information to investors as frequently as open-end funds. Accordingly, we would not recommend that the Commission treat ETFs differently from any other investment companies that use derivatives. In addition, we urge the Commission and the Staff to end the moratorium on exemptive orders for ETFs that use derivatives as quickly as possible.

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We appreciate the opportunity to respond to the Commission's request for comments, and we hope that these comments and observations contribute to the important work of the Commission. If you would like to discuss any of the matters raised in this letter, please do not hesitate to contact Nora Jordan at 212-450-4684, Danforth Townley at 212-450-4240, Gregory Rowland at 212-450-4930 or Aaron Schlaphoff at 212-450-4791.

Very truly yours,

[Signature]

DAVIS POLK & WARDWELL LLP