

# DEBEVOISE & PLIMPTON

875 THIRD AVENUE · NEW YORK, N.Y. 10022

(212) 909-6000

FRANCIS T.F. PLIMPTON  
1900-1983

OSCAR M. RUEBHAUSEN  
COUNSEL

CABLE: DEBSTEVE NEW YORK  
INTERNATIONAL TELEX: 234400  
DOMESTIC TELEX: 14-8377  
RAPIFAX: (212) 832-1475  
XEROX TELECOPIER (212) 750-927

WASHINGTON OFFICE  
1777 F STREET, N.W.  
WASHINGTON, D.C. 20006  
TELEPHONE: (202) 289-0100  
TELEX: 248392 DPDC UR  
RAPIFAX: (202) 289-0482

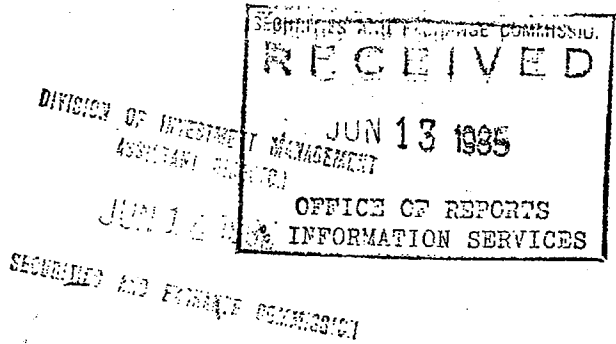
ROBERT J. GENIESSE  
RALPH C. FERRARA  
ROBERT R. BRUCE  
ERIC D. ROITER

EUROPEAN OFFICE  
5, PLACE DU PALAIS BOURBON  
75007 PARIS  
TELEPHONE: (1) 555-06-66  
TELEX: DEBSTEVE 250602F  
RAPIFAX (INFOTEC): (1) 551-86-60  
JAMES A. KIERNAN III  
DOMINIQUE BLANCO

ELI WHITNEY DEBEVOISE  
WILLIAM EVERDELL  
D. BRET CARLSON  
GEORGE N. LINDSAY  
STANLEY R. RESOR  
JAMES B. WELLES, JR.  
WELL B. PERKINS  
ERT B. VON MEHREN  
DLD H. HEALY, JR.  
EPH BARBASH  
CHESTER BILLINGS, JR.  
MICHAEL HARPER GOFF  
WILLIAM B. MATTESON  
BARRY R. BRYAN  
RICHARD D. KAHN  
ASA ROUNTREE  
GEORGE B. ADAMS, JR.  
ROBERT J. GENIESSE  
ANDREW C. HARTZELL, JR.  
PHILIP S. WINTERER  
STEPHEN BENJAMIN  
LOUIS BEGLEY  
GUY PASCHAL  
DAVID V. SMALLEY  
CECIL WRAY, JR.  
JAMES C. GOODALE  
JOHN F. JOHNSTON 2ND  
ROBERT L. KING  
BEVIS LONGSTRETH  
STEPHEN J. FRIEDMAN  
JOHN D. NILES  
MEREDITH M. BROWN  
BRUCE D. HAIMS  
STANDISH FORDE MEDINA, JR.  
EDWARD A. PERELL

THEODORE A. KURZ  
HUGH ROWLAND, JR.  
ROBERT J. GIBBONS  
MICHAEL E. PATTERSON  
BARBARA PAUL ROBINSON  
JONATHAN A. SMALL  
VINCENT M. SMITH  
PAUL H. WILSON, JR.  
WOLCOTT B. DUNHAM, JR.  
JEFFREY S. WOOD  
STEVEN M. ALDEN  
JOHN H. HALL  
JOHN G. KOELTL  
RALPH C. FERRARA  
JAMES A. KIERNAN III  
ROBERT R. BRUCE  
HANS BERTRAM-NOTHNAGEL  
MARTIN FREDERIC EVANS  
STEVEN R. GROSS  
ROGER E. PODESTA  
MARIO L. BAEZA  
WOODROW W. CAMPBELL, JR.  
GLEN LEWY  
MARCUS H. STROCK  
RALPH R. ARDITI  
DAVID A. DUFF  
MARY JO WHITE  
JONATHAN R. BELL  
ALAN H. PALEY  
ROBERT J. CUBBITO  
ERIC D. ROITER  
ROBERT N. SHWARTZ  
ROBERT J. STAFFARONI  
DARIUS TENCZA

\*ADMITTED IN DISTRICT OF COLUMBIA ONLY



June 12, 1985

Investment Company Act of 1940  
Sections 17(f) & 18(f)

Act	I CA - 40
Section	18(f)
File	
Public	
Availability	8/12/85

Office of Chief Counsel  
Division of Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

## Continental Option Income Plus Fund Stock Index Futures and Related Options

Gentlemen:

Continental Option Income Plus Fund (the "Fund") is the first series of Continental Mutual Funds Trust (the "Trust"), a diversified open-end management company established as a business trust under the laws of the Commonwealth of Massachusetts pursuant to a Declaration of Trust, dated April 19, 1985. The Trust filed a Registration Statement (Registration No. 2-97494) (the "Registration Statement") on May 3, 1985 under the Securities Act of 1933 (the "1933 Act") and the Investment Company Act of 1940 (the "1940 Act"), registering the shares of the Trust representing interests in the Fund under the 1933 Act and the Trust under the 1940 Act. Three copies of a current printer's proof of Pre-

Effective Amendment No. 1 to the Registration Statement (as submitted to the staff on June 12, 1985) are enclosed with this request.

The investment objective of the Fund, as stated in the enclosed Registration Statement, is to seek high current income while minimizing risk of loss of capital as a result of market fluctuations by investing primarily in dividend paying common stock and by writing covered call and covered put options. In addition the Fund will invest in options on common stock and stock indices and stock index futures and related options for the purpose of hedging its securities portfolio. At least 80% of the Fund's assets will normally be invested in a diversified portfolio of dividend paying common stock or in (a) the writing of covered call and covered put options primarily to generate current income; (b) the purchase and sale of put and call options on common stock to hedge against movements in individual common stock prices; (c) the purchase and sale of options on stock indices, the writing of covered put and call options on stock indices and the purchase and sale of stock index futures and related options to hedge against market-wide movements in common stock prices. The Fund will not engage in transactions in stock index futures or related options for speculation or to generate current income.

The Fund will maintain the flexibility to invest up to 20% of its assets to take advantage opportunities which offer, in the opinion of the Fund's subdivision, potential for short-term growth and income by aggressively investing in common stock, warrants for common stock and securities convertible into common stocks and by purchasing call options, writing put options and engaging in short sales "against-the-box". The securities in which it invests pursuant to this policy may or may not be the same as those purchased or sold pursuant to the hedged income policy but the strategies followed will involve more risk, and the possibility of a greater return, in that positions may not be hedged. The Fund will not engage in transactions in stock index futures or options thereon in pursuit of the policies referred to in this paragraph.

In pursuit of the foregoing policies the Fund anticipates using stock index futures contracts and related options to minimize capital risk. During or in anticipation of a period of market decline, the Fund may hedge its securities portfolio by selling stock index future contracts or purchasing put options thereon for the purpose of limiting the exposure of its portfolio to such decline. During or in anticipation of a period of market increase, the Fund may hedge a price risk by purchasing stock index futures and call options thereon which affords a hedge against not participating in such increase at a time when the Fund is not fully invested.

For further information on the Fund's investment objective and policies, including further information on the use of futures and related options, see pages 3 and 4 of the Prospectus included in the Registration Statement, the Appendix to the Prospectus beginning on page 11 and pages 3 through 16 of the Statement of Additional Information included in the Registration Statement.

As counsel to the Trust, we hereby request that the staff of the Division of Investment Management confirm to us its no-action position under Sections 17(f) and 18(f) of the 1940 Act with respect to the Fund's use of futures and related options as a hedging device. The Trust is also filing a notice of eligibility with the Commodity Futures Trading Commission ("CFTC") under Rule 4.5 of the CFTC regulations pursuant to which the Fund will be excluded from regulation as a "pool" and a "commodity pool operator".

#### Description of Stock Index Futures and Related Options

A stock index assigns relative values to the common stocks included in the index, and the index fluctuates with changes in the market values of the common stocks so included. A stock index futures contract is a bilateral agreement pursuant to which two parties agree to take or make delivery of an amount of cash equal to a specified dollar amount times the difference between the

stock index value at the closing of the last trading day of the contract and the price at which the futures contract is originally struck. No physical delivery of the underlying stocks in the index is made. The contracts in which the Fund will invest are traded on U.S. national securities exchanges or boards of trade.

When the Fund desires to purchase a stock index futures contract or to sell a related option, it will be required to deposit, for the account and in the name of the futures commission merchant (the "FCM") through which it is effecting transactions, in a segregated account with Investors Fiduciary Trust Company, the Trust's Custodian, an amount of cash or United States Treasury bills equal to approximately 5% of the contract amount in the case of a stock index futures contract. This amount is known as initial margin. No other consideration is paid or received upon the purchase or sale of the futures contract or upon the sale of a related option.

On each business day after the initial transaction the Fund makes or receives subsequent payments, called variation margin, to or from the FCM as the price of the futures contract fluctuates thereby making the long and short positions in the futures contract more or less valuable. This process is known as "marking to market" the futures contract or the option. The FCM has access to the amount of initial margin on deposit only if the Fund defaults in making payments of variation margin, and only after notice given by the FCM to the Fund accompanied by the FCM's statement to the Custodian that all conditions precedent to its rights to reach the initial margin have been satisfied.

Although the initial deposit and daily deposits are referred to as "margin", initial and variation margin in a stock index futures transaction are different from margin in a securities transaction. Initial margin does not involve the borrowing of funds by the Fund to finance the transaction. Initial margin is in the nature of a performance bond or good faith deposit on the contract, which is returned to the Fund upon termination of the futures contract, when all contractual obligations have

been satisfied. Variation margin does not represent a borrowing or loan by the Fund. It is a daily settlement between the Fund and the FCM of the amount one would owe the other if the contract expired or if the written option were exercised.

At any time prior to expiration of a stock index futures contract the Fund may elect to close the position by taking an opposite position. A final determination of variation margin will then be made, and if additional cash is required to be paid by or released to the Fund, the Fund will realize a loss or a gain.

As noted above, the Fund intends to purchase call and put options on stock index futures which are traded on U.S. exchanges or boards of trade and sell such options to terminate an existing position or let such options expire and settle the options for cash. Options on stock index futures are similar to options on stocks except that an option on a stock index future gives the purchaser the right, in return for the premium paid, to assume a position in a stock index futures contract (a long position if the option is a call and a short position if the option is a put), rather than to purchase or sell stock, at a specified exercise price at any time during the period of the option. Upon exercise of the option, the delivery of the futures position by the writer of the option to the holder of the option will be accompanied by delivery of the accumulated balance in the writer's futures margin account (which represents the amount by which the market price of the stock index futures contract, at exercise, exceeds, in the case of a call, or is less than, in the case of a put, the exercise price of the option on the stock index future). If an option is exercised on the last trading day prior to the expiration date of the option, the settlement will be made entirely in cash equal to the difference between the exercise price of the option and the closing level of the index on which the future is based on the expiration date.

The Commodity Exchange Act

The Fund intends to file a Notice of Eligibility with the CFTC under Rule 4.5 under the Commodity Exchange Act. As a result of such filing and compliance with the other provisions of Rule 4.5, the Fund will be excluded from the definition of "commodity pool operator" under the Commodity Exchange Act. The Fund will undertake in its Notice of Eligibility that it will use commodity futures or commodity options contracts solely for bona fide hedging purposes within the meaning of the CFTC's regulations, or, in the alternative, with respect to each long position in a commodity futures contract or related options contract that such long position will be used as part of the Fund's portfolio management strategy, will be incidental to the Fund's activities in the underlying cash market, and the underlying commodity value of such contract at all times will not exceed cash set aside in an identifiable manner, or short-term United States debt obligations or other United States dollar-denominated high-quality short-term money market instruments so set aside, plus any funds deposited as margin.

Undertakings

The Trust has authorized us to make the following undertakings on its behalf in connection with this request:

1. The Fund will enter into an arrangement with each FCM through which the Fund effects futures transactions pursuant to arrangements which provide in substance the following:

(a) The Fund will establish a custodial account with its Custodian to hold initial margin payments for Fund transactions in stock index futures contracts. Such account will be in the name of the FCM. The FCM will agree that assets in the account will at all times be maintained with the Custodian unless released to the Fund or otherwise disposed of as provided in the Fund's agreement with

FCM. Prior to disposing of assets in the account, the FCM will be required to state that all conditions precedent to its right to dispose of assets in the account are satisfied.

(b) The Fund will agree to pay to the FCM, and the FCM will agree to pay to the Fund, amounts equal to any change in the value of the Fund's open futures contracts, on a daily basis.

(c) The FCM will notify the Fund, after the close of trading each business day, of the amount or margin owed to or payable by the Fund for the account of the Fund no later than by 10:30 A.M. the next business day. All payments by the FCM to the Fund would be paid to the Custodian.

(d) It is the Fund's intent that any time the balance in the bank custodial account exceeds the required margin, the Fund will withdraw that excess promptly.

2. The Fund will not engage in transactions in futures contracts or related options for speculation but only as a hedge against changes resulting from market conditions in the value of securities held by the Fund or which it intends to purchase.

3. The Fund will not purchase or sell stock index futures contracts or purchase or sell related options if, immediately thereafter, the sum of the amount of margin deposits on the Fund's existing futures and related options positions and premiums paid for related options would exceed 5% of the market value of the Fund's total assets after taking into account unrealized profits and unrealized losses on any such contracts. In the case of an option that is in-the-money as defined in the CFTC's rules and regulations, the in-the-money amount may be excluded in computing the 5% limitation.

4. In instances involving the purchase of futures contracts or related call options by the Fund, cash or money market instruments equal to the market



value of the futures contract or related options (less any margin deposits thereon) will be earmarked in a segregated account with the Trust's Custodian to collateralize such long positions and thereby insure that the use of such futures contracts or related options is unleveraged. Such earmarked assets will not be used to support any other transactions in which the Fund may engage.

5. The Fund will file a Notice of Eligibility with the CFTC as aforesaid and will comply with the undertakings referred to therein. In addition, the Fund will not enter into any purchase or sell any stock index futures contract or related option if immediately thereafter, more than one-third of the Fund's net assets would be hedged.

6. The Fund's stock index futures contracts and related options contracts are governed by the terms and conditions of such contracts determined by the exchanges on which such contracts are traded, and its futures and related option positions are evidenced by confirmations of transactions received from the executing broker. The Fund's Custodian will have copies of such exchange's terms and conditions and that its Custodian will have possession of such confirmations.

#### Applicable 1940 Act Provisions

##### A. Section 18(f)

Section 18(f) of the 1940 Act provides that

"it shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer [except for certain borrowings from banks]."

If, as assumed in previous interpretive releases, "leveraged" investments by registered investment companies generally fall within the proscription of senior securities in Section 18 of the 1940 Act, a stock



index futures contract or the sale of a related option may, because of the Trust's contingent obligation to pay variation margin during the life of the stock index futures contract, constitute a "senior security" (as that term is defined in Section 18(g) of the Act), for the purpose of Section 18(f). Since such an obligation would not run to a bank, the purchase or sale of a futures contract or the sale of a related option thereon by the Fund could thus constitute the issuance of a senior security by the Trust in violation of Section 18(f)(1) of the Act.

If considered to be senior securities under the 1940 Act, the Trust believes that the proposed use by and limitations on the Fund with respect to such contracts and options do not give rise to the speculative abuses which Section 18(f)(1) was designed to prevent.\*

The limitations on the Fund's use of stock index futures contracts and related options, including the requirement that the futures and related options be used for hedging and not for speculative purposes, are consistent with the purposes of Section 18(f). The following considerations make the use of such futures and related options analogous to reverse repurchase agreements, standby commitments and other similar arrangements discussed in Investment Company Act Release No. 10666 (April 18, 1979) ("Release 10666"): (i) the Fund's undertaking not to engage in transactions in futures or related options for speculation, but only as a hedge; (ii) the 5% of total assets limitation on the Fund's payments of margin and premium and the 33% of net asset

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\* While the Trust maintains that stock index contracts and related options are not "securities" for the purposes of the 1940 Act (such contracts and options would thus not constitute "senior securities" under Section 18(g) or be subject to regulation under Section 18(f)(1)), in light of the other reasons discussed herein, it is not necessary to decide this point in granting the relief requested.

value limitation on total hedged position; and (iii) the collateralization of futures contracts and related options with cash or cash equivalents.

The staff of the Division has previously indicated that it would not object to investment company use of commodity futures contracts and related options for hedging purposes subject to similar limitations as described above. Drexel Series Trust-Government Securities Series [available April 25, 1985]; Prudential Bache Government Plus Fund, Inc. [available April 1, 1985]; Koenig Tax Advantaged Liquidity Fund, Inc. [available March 27, 1985]; Colonial Tax-Managed Trust [available December 31, 1984]; Monitrend Fund [available November 14, 1984]; Pilot Fund, Inc. [available September 14, 1984]; Colonial Option Income Trust-Portfolio II [available September 10, 1984]; Pension Hedge Fund Inc. [available January 20, 1984]; SteinRoe Bond Fund, Inc. [available January 17, 1984]; IDS Bond Fund, Inc. [available April 11, 1983].

B. Section 17(f)

Section 17(f) of the 1940 Act requires that "every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having [certain qualification]." Requirements for the purchase and sale of stock index futures and related options, such as the requirement that the Fund deposit with its broker an amount of cash or U.S. Treasury bills equal to approximately 5% of the contract amount of each futures contract entered into, necessitate custody arrangements that may raise questions under Section 17(f) of the 1940 Act.

The Division has indicated in previous letters that it would not object to custody arrangements for the deposit of margin payments on futures contracts, provided that certain standards were met. See Drexel Series Trust, supra; Prudential Bache Fund, supra; Koenig Tax Fund, supra; Colonial Tax-Managed Trust, supra; Monitrend, supra; Pilot Fund, Inc., supra; Colonial Option Income Trust, supra; Pension Hedge Fund, supra. Specifically, the Division has indicated that it would

June 12, 1985

not recommend action to the Commission if: (1) a margin account was established with its bank custodian in the name of a fund's FCM; (2) all amounts deposited in excess of required margin were withdrawn by the fund; and (3) the FCM were required to state that all conditions precedent to its right to direct disposition of amounts held in the account have been satisfied before it gains access to the account. In addition, gains due to the fund at the end of a clearing corporation's trading day must be paid to the fund no later than the next business day.

We believe that the specific custodial arrangements proposed pursuant to paragraph 1 under the heading "Undertakings" above meet the guidelines set forth by the Division in previous letters and are consistent with the letter and intent of Section 17(f).

#### Conclusion

In view of the foregoing, we request the advice of the Division that, subject to the compliance by the Trust with the undertakings set forth herein, that it will not recommend taking any action against the Fund in respect of any claimed issuance of senior securities in violation of Section 18(f) of the 1940 Act by virtue of its transactions in stock index futures and options on such futures as described herein. In addition, we request the advice of the Division that the custodial arrangements proposed by the Fund with regard to its transactions in futures contracts comply with Section 17(f) of the Act.

If you should have any questions regarding this request, please contact the undersigned at (212) 909-6779 or Charles A. Ruys de Perez of this office at (212) 909-6641.

Very truly yours,

Woodrow W. Campbell, Jr.

Enclosures

cc. Ms. Patsy Mengiste

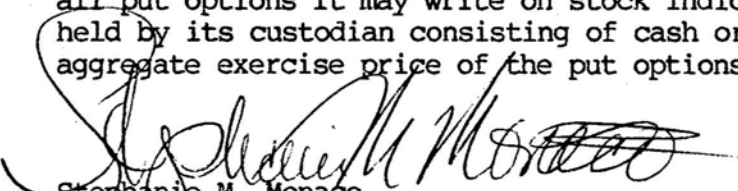
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JUL 12 1985

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 85-334-CC  
Continental Option Income  
Plus Fund  
File No. 811-4291

We would not recommend any enforcement action to the Commission under sections 17(f) and 18(f) of the Investment Company Act of 1940 if Continental Option Income Plus Fund ("Fund") proceeds as described in your letter of June 12, 1985. Our position is based on the facts and representations contained in that letter as well as the oral representations made to me on July 12, 1985, by Charles A. Ruys de Perez of your office that the Fund: (1) will not write call and put options on stock index futures; and (2) will collateralize all put options it may write on stock indices with a segregated account held by its custodian consisting of cash or cash equivalents equal to the aggregate exercise price of the put options.

  
Stephanie M. Monaco  
Attorney