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1940 Act  
Section 18(f)

March 30, 1987

BY HAND

Mary S. Podesta, Esq.  
Chief Counsel, Division of  
Investment Management  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 2054

Act	ICA-40
Section	18(f)
Rule	
Public	
Availability	6/22/87

Dear Ms. Podesta:

We are writing on behalf of investment company clients, including Dreyfus Strategic Investing and Dreyfus Strategic Income, to request your advice that the Staff will not recommend enforcement action if the funds engage to the extent described below in certain investment practices that raise issues under Section 18(f) of the Investment Company Act of 1940. These practices are:

1. Selling short.
2. Purchasing and selling futures contracts.<sup>1</sup>
3. Selling options, including options on specific securities, stock indexes and interest rate futures contracts.
4. Purchasing and selling currencies on a forward basis.

<sup>1</sup> The funds will comply with Rule 4.5 promulgated by the Commodity Futures Trading Commission or will be registered or otherwise exempt from registration as a commodity pool.

We believe current Staff interpretations on the application of Section 18(f)<sup>2</sup> restrict a fund's ability to use certain of these practices in a manner that reduces volatility risk more than alternative and clearly permissible strategies. We propose an alternative that we believe addresses the Staff's concerns under Section 18(f) and is consistent with published pronouncements of the Securities and Exchange Commission, but is less restrictive on the funds.

### I. Section 18(f) and Staff No-Action Positions

As the Staff has stated,<sup>3</sup> Section 18 is designed to mitigate the effects that excessive borrowing or the issuance of senior securities have on the investment experience of senior and junior security holders. The Staff reasons that Section 18 defines a senior security to include, among other things, any evidence of indebtedness, that entry into interest rate futures contracts and the selling of options gives rise to an evidence of indebtedness, and that, therefore, Section 18 issues are raised. The Staff has stated that selling securities short raises similar concerns as, we assume, would purchasing and selling currencies on a forward basis.

Entry into these transactions has been curtailed by imposing two restrictions: first, a deposit requirement and, second, the asset coverage requirement of Section 18. The deposit requirement appears to have its genesis in Release No. IC-10666 (the "Release"). In the Release, the Commission stated that certain transactions deemed to involve prohibited leverage<sup>4</sup> are effectively cleansed by requiring that cash or cash equivalents be segregated in amounts sufficient to cover all the "borrowing". The asset coverage requirement provides that certain borrowings are permitted only if "immediately after the borrowing there is asset coverage of at least 300 per centum for all borrowings of such registered company." Section 18(f). As the examples below suggest, the application of this dual prophylactic unduly restricts an investment company, while the application of the deposit requirement serves to protect fund shareholders from the concerns that Section 18 was enacted to address.

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2 These interpretations are discussed in Section I below.

3 See, Steinroe Bond Fund, Inc. (available January 17, 1984).

4 "Leverage is deemed to exist when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return." Release No. IC-10666, Footnote 5.

For purposes of understanding the examples, it may be useful to set forth in a formula our understanding of the Staff's position on Section 18. The formula, in substance, is that a fund's net assets plus (1) cash borrowings plus (2) the market value of the securities sold short<sup>5</sup> plus (3) the value of any commodity futures contracts (measured by multiplying the number of units to which the contracts pertain by the price per unit specified)<sup>6</sup> plus (4) the value of any security or contract underlying any options sold<sup>7</sup> plus (5) the value of the currency purchased or sold on a forward basis<sup>8</sup> must equal at least 300% of the value of the aggregate of items (1) through (5) above.

The asset segregation requirements, as we understand them, are as follows:

1. For naked short sales, a fund must deposit in a segregated account (not with the broker through which the transaction was effected) cash or U.S. Government securities equal in value to the difference between (a) the market value of the securities sold short at the time they were sold short and (b) any cash or U.S. Government securities required to be deposited as collateral with the broker in connection with the short sale (not including the proceeds of the short sale). In addition, until the borrowed security is replaced, the fund must maintain the segregated account at such a level that (a) the amount deposited in the account plus the amount deposited with the broker as collateral will equal the market value of the securities sold short and (b) the amount deposited in the account plus the amount deposited with the broker as collateral will not be less than the market value of the securities at the time they were sold short.<sup>9</sup>

2. For long futures contracts, the fund must deposit and maintain with its custodian cash, or earmark money market securities held by the custodian, equal to the fluctuating contract value of the long

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5 See, e.g., Pension Hedge Fund, Inc. (available January 20, 1984) and Guide 9 of Guidelines for Form N-1A.

6 See Investment Company Act Release No. 7221.

7 See, e.g., Koenig Tax-Advantaged Liquidity Fund, Inc. (available February 25, 1985).

8 Id.

9 See Guide 9 of Guidelines for Form N-1A.

futures contracts it has purchased, less any initial margin deposited in respect of the long positions.<sup>10</sup>

3. For options sold, the fund must segregate cash or cash equivalents<sup>11</sup> equal to the value of securities underlying the option.

4. For forward currency transactions, the fund must maintain in a segregated account, beginning on the date it enters into the forward contract, liquid assets equal in value to the purchase price due on the settlement date.

## II. Examples

### EXAMPLE 1

Purpose: To demonstrate that application of the asset coverage test to situations in which leverage effectively has been eliminated through maintenance of a segregated account restricts a fund's ability to engage in a beneficial defensive strategy.

	<u>Portfolio</u> <sup>12</sup>
Net assets prior to transaction	\$6.5 million of securities underlying the S&P 500; \$3.5 million of cash.
Transaction	(a) Sell short \$2.5 million of securities underlying the S&P 500; (b) Sell S&P 500 futures contracts having an underlying value of \$2.6 million.

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10 See, e.g., Prudential Bache IncomeVertible Plus Fund, Inc. (available November 20, 1985).

11 See, e.g., Continental Option Income Plus Fund (available August 12, 1985).

12 The transactions described in the examples are transactions in which the funds may desire to engage. The prices at which options and futures are purchased or sold in the examples are recent prices.

Also, segregate with the custodian and broker, in the aggregate, \$2.5 million (the market value of the securities sold short) and deposit \$78,000 as initial margin<sup>13</sup> on the futures contract.

Asset coverage 296%<sup>14</sup>

Compliance No

In this example, the portfolio would behave as if it were approximately 14% invested; that is, the purchase of \$6.5 million of securities would be hedged by \$5.1 million of short positions on similar securities. The unhedged position of \$1.4 million represents approximately 14% of net assets of \$10 million. This strategy might be desirable, for example, as a temporary substitute for subsequent portfolio sales if market conditions indicated a sharp, immediate decline and the portfolio could not be structured effectively in a more conventional defensive manner on a timely basis. Yet because of the asset coverage test, this strategy could not be implemented, even though the "leverage" was effectively eliminated through segregated deposits.

#### EXAMPLE 2

Purpose: To demonstrate that by using a seemingly prohibited futures strategy, it is possible to simulate in Portfolio B a portfolio that is one half as volatile as Portfolio A, with the result that risk of loss is less using the futures strategy.

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13 The amount of margin to be deposited in this and each succeeding example is the margin that might typically be required to be deposited in actual transactions.

14 The asset coverage in this example is determined using the following formula: The fund's net assets (\$10 million), plus (1) the market value of the securities sold short (\$2.5 million) plus (2) the value of the commodity futures contract (\$2.6 million), divided by the sum of (1) and (2) (\$5.1 million) equals 296%.

	<u>Portfolio A</u>	<u>Portfolio B</u>
Net assets prior to entry into transaction	\$10 million cash.	\$10 million cash.
Transaction	Borrow \$5 million from a bank; fully invest \$15 million in securities underlying S&P 500.	Purchase S&P 500 futures contracts having underlying contract value of \$7.5 million; deposit \$150,000 initial margin; segregate \$7.5 million in cash equivalents.
Composition of assets after application of funds	\$15 million fully applied to purchase of securities which are a part of the S&P 500; no cash held.	\$7.5 million of S&P 500 securities constructively owned <sup>15</sup> ; \$7.5 million of cash equivalents; \$150,000 initial margin deposit; remainder (\$2.35 million) held in cash or cash equivalents.
Asset coverage	300% <sup>16</sup>	233% <sup>17</sup>
Compliance with Section 18(f)	Yes	No

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- 15 In this and each succeeding example, transactions in futures and options serve as temporary substitutes for transactions in the underlying securities.
- 16 The asset coverage in this example is determined using the following formula: the fund's net assets (\$10 million) plus cash borrowings (\$5 million) divided by the amount of the cash borrowings (\$5 million) equals 300%.
- 17 The asset coverage in this example is determined using the following formula: the fund's net assets (\$10 million) plus the value of the commodity futures contract (\$7.5 million) divided by the value of the commodity futures contract (\$7.5 million) equals 233%.

In this example, Portfolio A moves exactly twice as much as Portfolio B and consequently is twice as risky. This is best demonstrated by assuming that the S&P 500 suddenly falls to zero. In such case, Portfolio A would have suffered losses approaching \$15 million while Portfolio B could lose no more than \$7.5 million. Yet the strategy employed in Portfolio A is permitted, while the strategy employed in Portfolio B is not, even though in Portfolio B liquid assets equal to the amount of the "leverage" were duly segregated.

EXAMPLE 3

Purpose: Same as in Example 2.

	<u>Portfolio A</u>	<u>Portfolio B</u>
Net assets prior to entry into transaction	In all respects, the same as in Example 2, except that securities underlying the S&P 100 are purchased.	\$10 million cash.
Transaction		Sell 300 January 245 put options on the S&P 100 at \$9 simulating, in a declining market, the purchase of \$7.35 million of securities underlying the S&P 100 <sup>18</sup> and receive a \$270,000 premium; segregate \$7.35 million in cash equivalents.

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<sup>18</sup> Determined by multiplying the number of options sold (300) by the price of the index (245) by the index multiplier (100), which equals \$7.35 million.



Composition of  
assets after  
application of  
funds

\$7.35 million of S&P  
100 securities con-  
structively owned; \$7.35  
million of cash equiva-  
lents; \$270,000 initial  
margin deposit; remainder  
(\$2.38 million) held in cash  
or cash equivalents.

Asset coverage

236%<sup>19</sup>

Compliance with  
Section 18(f)

No

Scenario 1: The S&P 100 declines from 240 to 220 or by 8.33%.

Portfolio A

Declines by \$1.25 million  
(8.33% of \$15 million)

Portfolio B

Declines by \$480,000  
(((245-220)x100x300)-270,000)<sup>20</sup>

Scenario 2: The S&P 100 declines from 240 to 180 or by 25%.

Portfolio A

Declines by \$3.75 million  
(25% of \$15 million)

Portfolio B

Declines by \$1.68 million  
(((245-180)x100x300)-270,000)

Scenario 3: The S&P 100 declines from 240 to 236 or by 1.67%.

Portfolio A

Declines by \$250,000  
(1.67% of \$15 million)

Portfolio B

Unchanged  
(((245-236)x100x300)-270,000)

<sup>19</sup> The asset coverage in this example is determined using the following formula: the fund's net assets (\$10 million) plus the value of the contract underlying the option sold (\$7.35 million) divided by the value of the contract underlying the option sold (\$7.35 million) equals 236%.

<sup>20</sup> The components of this formula are (a) the change in the S&P 100 (245 to 220), (b) the multiplier relating to the S&P 100 (100), (c) the number of options sold (300) and (d) the premium received (\$270,000).





Scenario 2: If the S&P 100 rises to 245.5 or 5%, the fund effectively has lost \$310,000  $((245.5-230) \times 200 \times 100)$  in respect of position A and has no loss in respect of position B. Since \$265,000 was received upon sale of the options, the portfolio would decline by \$45,000 or approximately .5%.

Scenario 3: If the S&P 100 declines from 233.75 to 230 or 1.6%, the fund has no loss in respect of position A and effectively has lost \$5 or \$100,000 in respect of position B, resulting in a profit of \$165,000.

Scenario 4: If the S&P 100 increases from 233.75 to 235 or .5%, the fund effectively has lost \$100,000 in respect of position A and has no loss in respect of position B, resulting in a profit of \$165,000.

Scenario 5: If the S&P 100 declines from 233.75 to 200 or 14.4%, the fund has no loss in respect of position A and effectively has lost \$700,000 in respect of position B, resulting in a loss of \$435,000 or 4.4%.

In this example, the effect of fluctuations in the portfolio is reduced as compared with a single option, yielding modest gains in some circumstances while reducing losses when the market moves dramatically. Yet this strategy is prohibited because of the failure to meet the asset coverage test as the result of each side of the transaction being treated as a separate borrowing.

The examples set forth above demonstrate only a few of the possible circumstances where volatility reducing management strategies are restricted by current interpretations of Section 18(f).

### III. Discussion

Financial futures, index options and other volatility reducing instruments and techniques have proliferated in recent years and their uses are now only beginning to be understood. Not surprisingly, it appears that the no-action requests to the Staff have been piecemeal and generally have failed to explore the implications of these investments and techniques. The result, we believe, is that the Staff appears to be treating these transactions both as the types of transactions to which the Release pertains and as the equivalent of cash borrowings to which the asset coverage test of Section 18 applies.

In the Release, the Commission stated that it was discussing only reverse repurchase agreements, firm commitment agreements and standby commitment agreements, but added: "However, if an investment company were to issue a security which affected its capital structure in a manner analogous to [such] agreements . . . , and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture." [Emphasis added.]

Mary S. Podesta, Esq.  
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Central to the Commission's analysis of the transactions is the conclusion that "the issue of compliance with Section 18 will not be raised with the Commission by the Division if the investment company 'covers' senior securities by establishing and maintaining 'segregated accounts'. The Commission agrees that segregated accounts, if properly created and maintained, would limit the investment company's risk of loss [by effectively limiting the leverage involved]."

The transactions to which this letter relates present the same leveraging issues as those raised by the Release and we believe should be analyzed in the same manner. Consistent with this analysis, we suggest that the excess borrowings sought to be avoided by Section 18(f) cannot exist to the extent that liquid assets are segregated against the eventual repayment of the borrowing. Accordingly, we request your concurrence with our view that, when instruments are held, or transactions are entered into, subject to the segregation requirements described above, "senior securities" for purposes of Section 18(f) will not be deemed to have been issued.

Very truly yours,

STROOCK & STROOCK & LAVAN

By



Thomas E. Hestler

**PUBLIC**

JUN 22 1987

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 87-202-CC  
Dreyfus Strategic Investing  
and Dreyfus Strategic Income  
File Nos. 811-4688; 811-4748

Your letter of March 30, 1987 requests our concurrence that the 300-percent asset-coverage requirement in Section 18(f) of the Investment Company Act of 1940 ("Act") would not apply if Dreyfus Strategic Investing and Dreyfus Strategic Income (the "Funds") hold instruments or enter into certain transactions subject to the staff's segregation requirements. The Funds will (1) sell securities short; (2) purchase and sell futures contracts; (3) purchase and sell options on specific securities, stock indexes, or interest rate futures contracts; and (4) purchase and sell forward contracts on currencies.

These types of transactions involve potential leveraging, which exists "when an investor achieves the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return," <sup>1/</sup> and issues under Section 18(f). Section 18(f) prohibits an open-end fund from issuing any senior security, but permits an open-end fund to borrow from a bank, if "immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company ...." In Investment Company Act Rel. No. 7221 (June 9, 1972) ("Release 7221"), the staff stated it would not object if a fund purchased or sold commodities or commodities contracts subject to certain restrictions, including 300-percent asset coverage of the contracts and other borrowings. <sup>2/</sup>

In Release 10666, the Commission discussed potential senior security and leveraging problems arising from certain fund trading practices. The release sets forth means by which funds can eliminate these problems, and thereby avoid the restrictions on trading in commodities set forth in Release 7221, through the segregation of fund assets. The staff has subsequently developed various segregation requirements for funds. To comply with these requirements, a fund with a long position in a futures or forward contract, or that sells a put option, must establish a segregated account (not with a futures commission merchant or broker) containing cash or certain liquid assets equal to the purchase price of the contract or the strike price of the put

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<sup>1/</sup> Investment Company Act Rel. No. 10666 (Apr. 18, 1975) ("Release 10666").

<sup>2/</sup> Among other restrictions set forth in Release 7221 are requirements that a fund engaging in commodity transactions maintain in a segregated account cash or U.S. government securities equal to the amount of initial margin required on each contract, that the fund not invest, including additional margin, more than twice the amount of the initial margin deposit in any commodities contract, and that the fund not invest in, or be contingently obligated in connection with, commodities contracts in an amount exceeding 10 percent of its assets.

option (less any margin on deposit). 3/ For short positions in futures or forward contracts, sales of call options, and short sales of securities, a fund may establish a segregated account (not with a futures commission merchant or broker) with cash or certain liquid assets that, when added to the amounts deposited with a futures commission merchant or a broker as margin, equal the market value of the instruments or currency underlying the futures or forward contracts, call options, and short sales (but are not less than the strike price of the call option or the market price at which the short positions or short sales were established). 4/

Segregation of fund assets is not required if a fund "covers" a long position or the sale of a put option. For example, instead of segregating assets, a fund that has a long position in a futures or forward contract could purchase a put option on the same futures or forward contract with a strike price as high or higher than the price of the contract held by the fund. A fund that has sold a put option could sell short the instruments or currency underlying the put option at the same or higher price than the strike price of the put option. Similarly, the fund could purchase a put option, if the strike price of the purchased put option is the same or higher than the strike price of the put option sold by the fund. 5/

In addition, a fund that engages in short sales, short positions, and sales of call options need not segregate fund assets if it "covers" these positions in the following ways. A fund selling a security short may own that security or hold a call option on that security with a strike price no higher than the price at which the security was sold. 6/ For example, a fund that sold 100 shares of XYZ stock short at \$50 per share would be covered if it held in its portfolio 100 shares of XYZ stock or if it held a call option permitting the fund to acquire 100 shares of XYZ stock at \$50 or less.

A fund with a short position in a futures or forward contract may cover by owning the instruments or currency underlying the contract. A fund may also cover this position by holding a call option permitting the fund to purchase the same futures or forward contract at a price no higher than the price at which the short position was established. For example, a fund selling a futures contract on the S & P 500 Index at 250 would be covered if the fund held a portfolio of securities substantially replicating the movement of the S & P 500 Index. 7/ Alternatively, the fund would be covered if it held a call option on an S & P 500 futures contract with a strike price of 250 or less.

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3/ See, e.g., Release 10666; Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Continental Option Income Plus Fund (pub. avail. Aug. 12, 1985); Koenig Tax-Advantaged Liquidity Fund, Inc. (pub. avail. Mar. 27, 1985); Pilot Fund, Inc. (pub. avail. Sept. 14, 1984); Pension Hedge Fund, Inc. (Jan. 20, 1984); SteinRoe Bond Fund, Inc. (Jan. 17, 1984).

4/ See Guide 9 of Guidelines for Form N-1A; see also Release 7221.

5/ See Release 7221.

6/ See Guide 9 of Guidelines for Form N-1A.

7/ See Putnam Option Income Trust II (pub. avail. Sept. 23, 1985).



A fund selling a call option on a security or stock index may cover its position by holding the same security (or, in the case of a stock index, a portfolio of stocks substantially replicating the movement of the index) underlying the call option. A fund may also cover by holding a separate call option on the same security or stock index with a strike price no higher than the strike price of the call option sold by the fund. For example, a fund selling a call option on 100 shares of XYZ stock with a strike price of \$50 per share would be covered if it held 100 shares of XYZ stock. The fund would also be covered if it held a call option on 100 shares of XYZ stock with a strike price of \$50 or less.

A fund selling a call option on a futures or forward contract may cover by entering into a long position in the same contract at a price no higher than the strike price of the call option. <sup>8/</sup> Similarly, a fund may cover by owning the instruments or currency underlying the futures or forward contract. A fund could also cover this position by holding a separate call option permitting it to purchase the same futures or forward contract at a price no higher than the strike price of the call option sold by the fund. For example, a fund selling a call option on an S & P 500 futures contract with a strike price of 250 would be covered if it entered into a long position in an S & P 500 futures contract at a price of 250 or less. In addition, the fund would be covered if it held a portfolio of stocks substantially replicating the movement of the S & P 500 Index. The fund would also be covered if it held a call option on the S & P 500 futures contract with a strike price of 250 or lower.

We agree that, if a fund meets the segregation requirements, a "senior security" would not be present and, therefore, the 300-percent asset-coverage requirement of Section 18(f) would not apply. <sup>9/</sup> In addition, if a fund has "covered" positions so as to eliminate any potential leveraging, as described above, the 300-percent asset-coverage requirement of Section 18(f) would not apply.

Accordingly, so long as the Funds comply with the staff's segregation requirements or "cover" positions as described above, we would not recommend any enforcement action to the Commission under Section 18(f) if the Funds engage in the transactions described in your letter without limiting these transactions to the 300-percent asset-coverage requirement contained in Section 18(f) of the Act.

As we agreed, this response will be made public immediately.

*Gerald T. Lins*  
Gerald T. Lins  
Attorney

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<sup>8/</sup> See Putnam Option Income Trust II (pub. avail. Sept. 23, 1985).

<sup>9/</sup> Under delegated authority from the Commission, the staff has granted exemptive relief on a similar question. See Investment Company Act Rel. Nos. 14690 (Aug. 21, 1985) and 15100 (May 15, 1986).