SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 271

[Release No. IC-10666]

Securities Trading Practices of Registered Investment Companies

AGENCY: Securities and Exchange Commission.

ACTION: General Statement of Policy.

SUMMARY: The Securities and Exchange Commission announces a general statement of policy with regard to the economic effects and legal implications under the Investment Company Act of 1940 of reverse repurchase agreements, firm commitment agreements, and standby commitment agreements entered into by registered investment companies. Further, the Commission announces the views of the Division of Investment Management regarding repurchase agreements entered into by registered investment companies with broker/dealers.

EFFECTIVE DATE: April 18, 1979.

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SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") today announced a general statement of policy under the Investment Company Act of 1940 [15 U.S.C. 80a *et seq.*] ("Act") regarding the effect on the capital structure of registered investment companies of certain securities trading practices known as the reverse repurchase agreement, the firm commitment agreement, and the standby commitment agreement. Such practices may involve the issuance by the investment company of a senior security subject to the prohibitions and asset coverage requirements of Section 18 of the Act [15 U.S.C. 80a–18]. The board of directors of each registered investment company should review present securities trading practices to determine if the investment company is involved in any of the practices under discussion, or in similar trading practices with comparable effects on the capital structure of the investment company. Directors of investment companies, in the exercise of their general fiduciary obligations under the Act, should consider whether the investment company has appropriately segregated assets in a manner which would satisfy the legislative purposes of Section 18 of the Act. If an investment company is involved in such securities trading practices, the directors should review the adequacy of the investment company's disclosure of its participation therein, and the risks of loss to the investment company and its shareholders which may result from such securities trading practices. Directors should review also the adequacy of their valuation of, and accounting for, such transactions. Directors should further determine whether such trading practices, because of their inherent risk, are consistent with the policies of the investment company as recited in its registration statement, or cause its name to be deceptive or misleading.

In addition, the Commission is publishing the views of its Division of Investment Management ("Division"), which has reconsidered its prior position that, pursuant to Section 12(d)(3) of the Act [15 U.S.C. 80a–12(d)(3)], an investment company may be prohibited from entering into a repurchase agreement with a broker/dealer. Under certain circumstances, the Division has determined not to recommend to the Commission that action be taken under Section 12(d)(3) of the Act against investment companies which engage in repurchase agreements with broker/dealers.

Although the general statement of policy discusses securities trading practices of open-end investment companies and uses specific types of U.S. government guaranteed securities as examples, it is intended to address the use by all registered investment companies of similar trading practices involving all types of securities.

Background

Section 18(f)(1) of the Act [15 U.S.C. 80a–18(f)(1)] provides, in part, that it shall be unlawful for any registered open-end investment company ("investment company") to issue any class of senior security or to sell any senior security of which it is the issuer, except that the investment company shall be permitted to borrow from any bank, provided that immediately after any such borrowing there shall be an asset coverage of at least 300 per centum for all borrowings of the investment company as computed under Section 18(h) of the Act [15 U.S.C. 80a–18(h)]. Section 18(g) of the Act [15 U.S.C. 80a–18(g)] defines "senior security" to means, in part, "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness." Section 2(a)(36) of the Act [15 U.S.C. 80a–2(a)(36)] defines "security" to mean, in part, "any note, stock, treasury stock, debenture, evidence of indebtedness, . . . or, in general, any interest or instrument commonly known as a 'security.' "

In this statement of policy, the Commission is expressing its views only with regard to those securities trading practices under discussion in view of the unique legislative purposes and policies underlying Section 18 of the Act, and not generally with respect to the definition of security or to particular types of securities within that definition. However, if an investment company were to issue a security which affected its capital structure in a manner analogous to the agreements discussed herein, and barring other material differences, the Commission believes it would view that transaction from a similar analytical posture. Nonetheless, this general statement of policy with respect to Section 18 of the Act should not be read as stating any opinion as to whether the securities trading practices under discussion would constitute the issuance of securities for purposes of the Securities Act of 1933 [15 U.S.C. 77a, *et seq.*], the Securities Exchange Act of 1934 [15 U.S.C. 78a, *et seq.*], or the other federal securities laws.

Areas of Concern

The Commission has become aware of certain securities trading practices engaged in by investment companies which raise serious questions as to whether such practices involve the issuance of senior securities by the investment companies and, thus, are either prohibited by, or subject to the asset coverage requirement of, Section 18(f)(1).[1]

The securities trading practices which concern the Commission are generally known as the reverse repurchase agreement, the firm commitment agreement, and the standby commitment agreement. Often, the underlying securities involved in these agreements are guaranteed as to payment of principal and interest by the U.S. government, its agencies, or federally sponsored quasi-public corporations, e.g., modified pass through securities guaranteed by the Government National

[1] This release suggests an analysis of and some limitations upon certain securities trading practices of open-end investment companies. These practices may have similar effects on closed-end investment companies, which also are subject to restrictions on their capital structures under Section 18. For example, Section 18(a) of the Act [15 U.S.C. 80a–18(a)] makes it unlawful for a closed-end investment company to issue senior securities unless asset coverage and other requirements are met. Therefore, as the circumstances require, the analysis and recommendations contained in this release are addressed also to directors of closed-end investment companies.

Mortgage Association ("Ginnie Maes"). In the following discussion of these transactions, reference to "Ginnie Maes" is made only to serve as an example of the underlying security, and such reference should not be construed as delimiting this statement. Rather, this release is intended to illustrate the Commission's concern with the possible economic effects and legal implications of the securities trading practices herein discussed, regardless of whether the underlying securities are U.S. government obligations, government agency obligations, or other types of securities. Furthermore, because such types of securities trading practices are subject to innumerable variations, this release is intended to address generally the possible economic effects and legal implications of all comparable trading practices which may affect the capital structure of investment companies in a manner analogous to the securities trading practices specifically discussed herein.

The Commission recommends that each investment company board of directors review its present securities trading practices to determine if the investment company is involved in the practices under discussion, or in other trading practices with comparable effects on the capital structure of the investment company.

Reverse Repurchase Agreements

In a typical investment company reverse repurchase agreement,[2] an investment company is the record owner of a Ginnie Mae. The investment company transfers possession of the Ginnie Mae to another party (often a broker/dealer or a bank) in return for a percentage of the value of the Ginnie Mae, usually 90–97% [3] of its market value ("proceeds"), but retains record ownership and the right to receive interest and principal payments on the Ginnie Mae. At an agreed upon future date, the investment company repurchases the Ginnie Mae so transferred by remitting the proceeds plus interest. In a "continuing contract" agreement, there is no agreed upon repurchase date; during its existence, the agreement is treated as if it were reestablished each day. When the agreement takes such form, interest payments are calculated daily and often are based on the prevailing overnight repurchase rate. The flexible maturities of the agreements, as short as one business day or as long as desired by the parties, make them attractive investment and borrowing tools for both parties to the transaction.

The Commission believes that, in economic reality, the reverse repurchase transaction is a loan to an investment company by the other party, collateralized by the security, because all of the incidents of ownership of the security are retained by the investment company. Furthermore, even if the form of the transaction were altered to reflect more closely an actual sale and repurchase of a Ginnie Mae instead of a transfer of a security in conjunction with a loan, the proceeds of the initial sale would still be considered to be a borrowing by the investment company under Section 2(a)(23) of the Act [15 U.S.C. 80a–2(a)(23)], which defines "lend" to include "a purchase coupled with an agreement by the vendor to repurchase" and defines "borrow" to include "a sale coupled with a similar agreement."

Investment companies may choose to engage in reverse repurchase agreements for two reasons. First, reverse repurchase agreements could be used to finance the purchase of interest bearing securities, allowing the investment company to derive income from the interest rate differential between the cost of borrowing and the return on the security purchase with the proceeds. For example, an investment company would purchase a Ginnie Mae. On settlement date, it would enter into a reverse repurchase agreement with the seller of the Ginnie Mae, and use the proceeds obtained from the reverse repurchase agreement to reduce the amount owed on the purchase. The investment company could thereby complete the purchase of the security by investing cash amounting to only 3–10% (typically) of the value of the security. The investment company's objective would be, then, to realize net income on the differential between the yield it would receive from the Ginnie Mae and the interest it would pay for the use of the proceeds.

Second, an investment company could enter into a reverse repurchase agreement with a Ginnie Mae it already owns. By so doing, it would obtain additional cash to invest in other securities. In such a case, the investment company's objective would be, then, to obtain funds to pursue additional investment opportunities whose yield would exceed the carrying cost of the proceeds of the reverse repurchase agreement.

In each of the above circumstances, the reverse repurchase agreement entered into by the investment company constitutes a borrowing by the investment company and, concurrently, may involve the issuance by it of an evidence of indebtedness. Section 2(a)(36) of the Act defines "security" to include any "evidence of indebtedness". Thus, an investment company which enters into a reverse repurchase agreement may be involved in the issuance of a security which, in turn, may be a senior security as defined in Section 18(g) of the Act. This view is further supported by Section 18(f)(1) which, by implication, treats all borrowings as senior securities. Section 18(f)(1) of the Act prohibits such borrowings unless entered into with banks and only if there is 300% asset coverage on all borrowings of the investment company.

The legislative history of the Act indicates that Congress intended Section 18, *inter alia,* to limit increases in the speculative character of junior securities issued by investment companies.[4] Leveraging [5] of an investment company's portfolio through the issuance of senior securities and through borrowing magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities. Leveraging without any significant limitation was identified by the staff of the Investment Trust Study of 1939 and by the investment company industry as one of the major abuses of investment companies prior to the passage of the Act by Congress.[6] Absent

[2] As the terms are used herein, in a reverse repurchase agreement, the investment company borrows money; in a repurchase agreement, the investment company lends money. In the marketplace, various terms are used to describe reverse repurchase and repurchase agreements, including "reverse repo," "repo" and "buy back."

[3] This percentage is subject to negotiation and can exceed 100%. Because, however, the proceeds typically are less than the current market value of the security, the latter overcollateralizes the loan, giving the lender added protection in the event of default.

[4] See memorandum entitled "Provisions of the Proposed Bill Relating to Capital Structure (Sections 18, 19(b) and 21(c))." introduced by L.M.C. Smith (Associate Counsel, Investment Trust Study, Securities and Exchange Commission), *Hearings on S. 3580 before a Subcommittee of the Senate Committee on Banking and Currency,* 76th Congress, 3rd Sess. at 1025 (1940) (herinafter cited as "Senate Hearings").

[5] Leverage 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. See Senate Hearings at 240. Through a reverse repurchase agreement, an investment company can achieve a return on a very large capital base relative to its cash contribution. Therefore, the reverse repurchase agreement is a highly leveraged transaction.

[6] "The conclusion to be drawn from the operation of the principle of leverage and from these statistics is that the common stock of leverage investment companies is so fraught with danger to the investor and so hazardous a commodity that it is definitely inappropriate as an offering of a public investment

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regulation under Section 18 of the Act, an investment company potentially could pyramid leveragings by entering into reverse repurchase agreements using securities purchased with the proceeds of earlier reverse repurchase agreements.[7] Pyramiding through the reverse repurchase technique can substantially magnify the risk of investing in, or holding shares of, the investment company; while net assets remain the same, total risk to investors increases commensurate with the increase in gross assets.

It appears that, if investment company participation in reverse-repurchase agreements is not subject to limitation, one of the important policies underlying Section 18 would be rendered substantially nugatory. Directors of investment companies should consider the Congressional purpose behind Section 18 and, additionally, the Congressional concerns articulated in Sections 1(b)(3), 1(b)(7), and 1(b)(8) of the Act [15 U.S.C. 80a-1(b)(3), 1(b)(7), 1(b)(8)] in considering whether the securities trading practices of the investment company involved, including reverse repurchase agreements, constitute the issuance of senior securities by the investment company.[8] Directors should consider also whether the investment company engages in similar securities trading practices, not specifically the subject of this release, which have comparable leveraging effects on the capital structure of the investment company.

Exclusion for Temporary Borrowing

Section 18(g) of the Act provides an exclusion from the definition of "senior security" for certain privately arranged loans for temporary purposes.[9] The section states that loans repaid within sixty days shall be presumed to have been made for temporary purposes if not extended or renewed. Although neither "extension" nor "renewal" is defined in the Act, the Commission believes that an extension or renewal would include any substantially similar temporary loan entered into within sixty days of the previous temporary loan, whether or not both loans were made with the same lender. Thus, both loans might fall outside that exclusion from the definition of senior security.

Reverse repurchase agreements could be designed to appear to fall within the exclusion from the definition of senior security for temporary loans created for less than sixty days. Such agreements could then be "rolled-over," perhaps indefinitely, with such short-term borrowings being entered into, closed out, and later re-entered. If substantially similar "temporary loans" were being "rolled over" in any manner for a total period of sixty days or more, the later loans would be treated as renewals of the earlier loan and, thus, all would fall outside the exclusion for "temporary loans."

Firm Commitment Agreements

The firm commitment agreement[10] is a buy order for delayed delivery[11] in which an investment company agrees to purchase a Ginnie Mae from a seller (usually a broker/dealer) at a future date, stated price, and fixed yield.[12] The agreement binds the seller as to delivery and binds the investment company as to acceptance. Agreements frequently permit substitution of a different Ginnie Mae with a stated yield different from the contract rate, so long as there is an appropriate adjustment to the purchase price that results in a yield to expected maturity equal to the yield originally committed. In general, no fee is required to be paid at the time of entering into Ginnie Mae firm commitment agreements.

The value of fixed yield Ginnie Maes to be delivered in the future will fluctuate as interest rates vary. Because of the effect that interest rate changes have on such securities in the marketplace, even before delivery of a Ginnie Mae, the firm commitment contract may represent an unrealized gain or loss on the security to be delivered. On or before settlement date, the investment company generally has the option of closing out the purchase obligation, rather than purchasing the security, by assigning the contract. For example, in a falling interest rate market the investment company could sell the firm commitment agreement for immediate profit. Conversely, in a rising interest rate market the investment company could assign the firm commitment, prior to the settlement date, and accept an immediate loss, measured by the amount the investment company would be required to pay to the purchaser to accept the assignment or to the seller to forgo its rights under the contract. If a firm commitment is held until settlement, the investment company, in purchasing the Ginnie Mae, will pay the commitment price regardless of the current market value of the Ginnie Mae.

Whether or not a firm commitment is held until settlement, it creates the potential for profit or loss without any investment because interest rate changes in the marketplace affect the value of the security to be delivered. In economic reality, this can be characterized as unlimited leverage.[13]

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institution, especially upon consideration of the sales emphasis of investment companies upon the savings and investment character of the securities of such companies." Senate Hearings at 1029.

[7] Leverage through reverse repurchase agreements creates the risk of magnified capital losses which occur when losses affect an asset base, enlarged by borrowing, that exceeds the equity base of the investment company. Pyramiding of reverse repurchase agreements requires the investment company to seek investments which can produce income sufficient to cover fixed interest charges on the proceeds. This situation may result in unusual pressure on investment company management to find investments with sufficient yield without regard to their quality or suitability for the investment company. This same pressure existed where multiple layers of preferred stock were issued by investment companies prior to the passage of the Act. See Senate Hearings at 1038.

[8] Sections 1(b)(3), 1(b)(7), and 1(b)(8) of the Act declare, in part, that the national public interest and the interest of investors are adversely affected: when investment companies fail to protect the preferences and privileges of the holders of their outstanding securities; when investment companies, by excessive borrowing and the issuance of excessive amounts of senior securities, increase unduly the speculative character of their junior securities; and when investment companies operate without adequate assets or reserves.

[9] Section 18(g) provides, in part, that senior security "when used in this section 18 [shall not] include any such promissory note or other evidence of indebtedness in any case where such a loan is for temporary purposes only and in amount not exceeding 5 per centum of the value of the total assets of the issuer at the time when the loan is made. A loan shall be presumed to be for temporary purposes if it is repaid within sixty days and is not extended or renewed; otherwise it shall be presumed not to be for temporary purposes. Any such presumption may be rebutted by evidence."

[10] The firm commitment is known by other names such as a "forward contract," a "when-issued security," a "mandatory," or, if delivery is called for within 30 days, an "immediate."

[11] The Commission recognizes that, for example, in the ordinary purchase of equity securities there is often a delay of a few days between the purchase of the security, and clearance and settlement. This general statement of policy respecting Section 18 of the Act is not intended to address arrangements involving the purchase of equity securities where the delay in delivery involves, for example, only the brief period usually required by the selling party and its agent solely to locate appropriate stock certificates and prepare them for submission for clearance and settlement in the customary way.

[12] Commitments to purchase securities whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in this general statement of policy. Such commitments neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage.

[13] Because most traditional leveraging techniques require some cash investment, an investor's ability to leverage is limited by available cash. Firm commitments require no cash investment, which removes the most significant restriction on the increasing use of leverage. The degree of leverage is often measured by the ratio between the additional cash upon which the investor receives a right to a return and the investor's own cash investment. If the investor puts up nothing, leverage cannot be measured in ratio terms, and therefore can be said to be unlimited or infinite.

Exposure of an investment company's assets to risk of loss is borne proportionately by all the securities issued by the investment company, so that the speculative character of such securities in the hands of investors increases as the investment company enters into increasing numbers of firm commitment agreements.

An investment company's participation in a firm commitment agreement may involve the issuance of a security by the investment company. Section 2(a)(36) of the Act defines the term "security" to mean any evidence of indebtedness. Because a firm commitment is an obligation to pay in the future for consideration presently received, it may involve the issuance of an evidence of indebtedness by the investment company. Thus, if a firm commitment agreement is a security, because it evidences an indebtedness of the investment company, it also may be a senior security as defined in Section 18(g) of the Act, and an investment company entering into such agreements may be in violation of Section 18(f)(1).

Standby Commitment Agreements

The standby commitment agreement is a delayed delivery agreement in which the investment company contractually binds itself to accept delivery of a Ginnie Mae with a stated price and fixed yield upon the exercise of an option held by the other party to the agreement at a stated future date. The investment company receives an individually negotiated, non-refundable commitment fee in consideration for its agreement to "standby" to purchase the Ginnie Mae. The Commission believes that the standby commitment agreement involves, in economic reality, the issuance and sale by the investment company of a "put."

If an investment company is successful in predicting interest rate movements, the standby commitment agreement may be used by an investment company to earn commitment fee revenues without investment or cost. For example, if an investment company entered a standby commitment and interest rates in the marketplace declined, the broker/dealer (who paid the fee) would retain the security stated in the agreement, or sell it to a third party at the current market price. The contract would be allowed to lapse and the investment company would have earned its fee without investment or cost.

The standby commitment agreement creates a risk of loss to the investment company and its shareholers well in excess of the commitment fees the investment company would receive as consideration for entering into the agreement. The market value of a Ginnie Mae, which often has a face value in excess of $1,000,000, will be materially affected when even slight changes occur in the current market interest rate. For example, if interest rates in the marketplace increase after the agreement is made, it is likely that the contract price on the delivery date will exceed the then current market value of the Ginnie Mae. The broker/dealer can be expected to exercise its option and, in effect, pass the decline in the value of the Ginnie Mae to the investment company. That decline in value may significantly exceed the fee received by the investment company for entering into the agreement.

An investment company's participation in a standby commitment agreement may involve the issuance of a security by the investment company. Section 2(a)(36) of the Act defines the term "security" to mean any "evidence of indebtedness" and "any interest or instrument commonly known as a 'security.'" Because a standby commitment agreement is a contingent obligation to pay in the future for consideration presently received, it may involve an issuance of an evidence of indebtedness by the investment company. Furthermore, as noted, the standby commitment is or at least closely resembles a "put" which is generally regarded as a security and is included within the definition of security in Section 2(a)(36). Thus, a standby commitment agreement may be considered a security under either or both of these theories and, further, a contingent evidence of indebtedness of the investment company. Therefore, an investment company involved in standby commitment agreements, if they are senior securities as defined by Section 18(g) of the Act, may be in violation of Section 18(f)(1) of the Act.

The Agreements as Securities

The Commission believes that reverse repurchase agreements, firm commitment agreements, and standby commitment agreements fall within the functional meaning [14] of the term "evidence of indebtedness" for purposes of Section 18 of the Act. Generally, included within it would be all contractual obligations to pay in the future for consideration presently received; the term would not be limited to notes or other acknowledgments of debt. The Commission's views are based not so much on the conclusion that reverse repurchase agreements and firm commitment agreements, considered in isolation, are inherently securities for all purposes, but more upon the proposition that trading practices involving the use by investment companies of such agreements for speculative purposes or to accomplish leveraging fall within the legislative purposes of Section 18.

The Commission has reviewed the legislative history and the Congressional intent underlying the Act. In light of the concerns discussed therein, the Commission believes that its construction of "evidence of indebtedness" in Section 2(a)(36) of the Act, for purposes of Section 18 of the Act, is reasonable because the fundamental economic nature of reverse repurchase, firm commitment, and standby commitment agreements is such that each poses a risk of loss to an investment company analogous to the danger caused by leverage, which is discussed throughout the legislative history of the Act. The Commission believes that the agreements being considered cannot be viewed merely as contracts for the acquisition of the underlying securities; rather, the agreements are securities separate from the underlying Ginnie Maes. The decision to enter into such agreements involves considerations and determinations which are separate and distinct from those involved in the purchase of Ginnie Maes. A Ginnie Mae, because of its government guarantee, is viewed as a low risk investment. Each of the reverse repurchase agreement, firm commitment agreement, and standby commitment agreement may be a substantially higher risk investment because of the additional risk of loss created by the substantial leveraging in each agreement, and in light of the volatility of interest rates in the marketplace. The gains and losses from the transactions can be extremely large relative to invested capital; for this reason, each agreement has speculative aspects. Therefore, it would appear that the independent investment decisions involved in entering into such agreements, which focus on their distinct risk/return characteristics, indicate that, economically as well as legally, the agreements should be treated as securities separate from the underlying Ginnie Maes for purposes of Section 18 of the Act.

Segregated Account

In circumstances involving similar economic effects, such as short sales of securities by investment companies, the

[14] "The starting point in every case involving the construction of a statute is the language itself." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1976).

Division of Investment Management has determined that the issue of compliance with Section 18 will not be raised with the Commission by the Division if the investment company "covers" the senior security by establishing and maintaining certain "segregated accounts."[15] The Commission agrees that segregated accounts, if properly created and maintained, would limit the investment company's risk of loss. The board of directors of an investment company which is engaged in reverse repurchase agreements, firm commitment agreements or standby commitment agreements should review the investment company's portfolio and custodial accounts to determine if any segregated accounts with the company's custodian have been, or should be, created.

A segregated account freezes certain assets of the investment company and renders such assets unavailable for sale or other disposition. If an investment company continues to engage in the described securities trading practices and properly segregates assets, the segregated account will function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative character of its outstanding common stock. Additionally, such accounts will assure the availability of adequate funds to meet the obligations arising from such activities.

The Commission believes that only liquid assets, such as cash, U.S. government securities or other appropriate high grade debt obligations, should be placed in such segregated accounts. Segregated assets may be replaced by other appropriate non-segregated assets of equal value. The value of U.S. government securities or other assets in an account should be marked to the market daily, and additional assets should be placed in the segregated account whenever the total value of the account falls below that amount described in the following guidelines. With respect to the segregation of assets, the Commission recommends:

(1) With regard to each reverse repurchase agreement which lacks a specified repurchase price, the investment company should maintain in a segregated account (not with a broker), beginning on the date the investment company enters into the reverse repurchase agreement, liquid assets equal in value to the proceeds received on any sale subject to repurchase plus accrued interest. If the reverse repurchase agreement has a specified repurchase price, the investment company should maintain in the segregated account an amount equal to the repurchase price, which price will already include interest charges.

(2) With regard to each firm commitment agreement the investment company should maintain in a segregated account (not with a broker), beginning on the date the investment company enters into the firm commitment agreement, liquid assets equal in value to the purchase price due on the settlement date under the firm commitment agreement.

(3) With regard to each standby commitment agreement, the investment company should maintain in a segregated account (not with a broker), beginning on the date the investment company enters into the standby commitment agreement, liquid assets equal in value to the purchase price under the standby commitment agreement.

Directors should note that, as asset segregation reaches certain levels, an investment company may impair its ability to meet current obligations, to honor requests for redemption, and to manage properly the investment portfolio in a manner consistent with its stated investment objectives. For example, in an extreme case an investment company which has segregated all its liquid assets might be forced to sell non-segregated portfolio securities to meet its obligations upon shareholder requests for redemption. Such forced sales could cause an investment company to sell securities which it wanted to retain or to realize gains or losses which it did not originally intend. Therefore, directors should consider such potential loss of flexibility when determining the extent to which the investment company should engage in such transactions.

Investment Company Policies

Sections 8(b) (1), (2) and (3) of the Act [15 U.S.C. 80a-8(b)(1), 8(b)(2), 8(b)(3)] provide, in part, that every investment company shall file with the Commission recitals of its policies with respect to certain specified activities including the borrowing of money and the issuance of senior securities, certain investment policies that are changeable only if authorized by shareholder vote, and certain policies which the registrant deems fundamental. Sections 13(a) (2) and (3) [15 U.S.C. 80a-13(a)(2), 13(a)(3)] provide, in part, that no investment company, unless authorized by the vote of a majority of its outstanding voting securities, shall borrow money or issue senior securities except in accordance with the recitals of policy contained in its registration statement or deviate from any fundamental policy or any investment policy which is changeable only if authorized by a shareholder vote.

To ensure compliance with Section 13 of the Act, directors of an investment company should determine whether the securities trading practices of the investment company are consistent with the policies recited pursuant to Section 8(b) of the Act. Directors should consider whether the investment company has designated the preservation of capital or the growth of capital through "conservative" investment strategies as a fundamental policy or a policy changeable only by shareholder vote. If so, it may be inappropriate for the investment company to engage to a material extent in the securities trading practices which have been discussed above.

Valuation and Accounting

The securities trading practices discussed above may also create valuation problems. Changes in the value of a firm commitment agreement, for example, will affect the price at which the shares of an investment company may be sold, redeemed or repurchased. Section 22(c) of the Act [15 U.S.C. 80a-22(c)] and Rule 22c-1 [17 CFR 270.22c-1] thereunder require, in part, that such sales, redemptions and repurchases be effected at current net asset value. Section 2(a)(41) of the Act [15 U.S.C. 80a-2(a)(41)] and Rule 2a-4 [17 CFR 270.2a-4] thereunder require that, in determining net asset value, securities for which market quotations are readily available must be valued at current market value while other securities and assets must be valued at fair value as determined in good faith by the board of directors. Accordingly, directors should review their current valuation procedures, accounting systems, and systems of internal accounting control to determine whether any inadequacies exist with regard to the valuation and accounting treatment of such securities trading practices.

With respect to the proper accounting treatment of such securities trading practices, different treatment may be accorded firm[16] and standby

[15] See Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221, pp. 6-8 (June 9, 1972).

[16] In deciding upon the treamont a firm commitment should receive in the investment company's accounting records, the board of directors should consider the position of the American Institute of Certified Public Accountants concerning how municipal bond funds should account for certain municipal bonds purchased on a "when issued" basis. In part, this paragraph states:

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commitments. Because standby commitments and listed put options have similar financial attributes and because it is possible to value the securities underlying the standby commitment by reference to market prices and interest rates for existing Ginnie Mae securities, the board of directors should consider accounting procedures used for listed put options in determining how a standby commitment should be treated in the investment company's accounting records.[17]

Disclosure

As stated above, use of the reverse repurchase agreement, the firm commitment agreement, and the standby commitment agreement creates the potential for substantial losses to an investment company. The directors of an investment company using such securities trading practices should review documents filed with the Commission and provided to investors and shareholders pursuant to the federal securities laws [18] to ensure complete disclosure of all pertinent information regarding the nature and consequences of the investment company's participation in such transactions. Specifically, disclosure materials should focus on, and comments by the Division during the review process will be directed to, the potential risk of loss presented to an investment company and its investors by those transactions; the identification of the securities trading practices as separate and distinct from the underlying securities; the differing investment goals inherent in participating in the securities trading practices as compared to those of investing in the underlying securities; and any other material information relating to such practices and the investment company's participation therein. Based on historical experience, the Commission believes that disclosure including the risk of loss to an investor in an investment company engaging in the practices described is necessary to ensure that the investment company will not be offering for sale or selling securities by means of a false, misleading or deceptive statement of a material fact in a prospectus.[19] Failure to disclose material information to shareholders in such documents would result in violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. In connection with the foregoing, directors of investment companies which engage in the securities trading practices under discussion should also consider whether the investment company's name accurately reflects its portfolio investment policies and securities trading practices.[20]

Division Position Respecting Repurchase Agreements With Broker/Dealers

In recent "no-action" correspondence,[21] the Division of Investment Management stated that it could not assure that it would not recommend action under Section 12(d)(3) of the Act [22] against an investment company if it entered into certain repurchase agreements with a broker/dealer. The Division has reconsidered the position taken therein and, because of the relevancy of that position to the general discussion by the Commission of the applicability of Section 18 of the Act to certain securities trading practices, has requested that the Commission publish the Division's current position, which follows.

A repurchase agreement differs from the reverse repurchase agreement in that the investment company lends rather than borrows money. In a typical investment company repurchase transaction, an investment company purchases securities from a broker/dealer (the purchase price being the "proceeds"), and agrees to resell such securities to the same broker/dealer at a later date. Upon resale, the investment company receives the proceeds plus an amount which represents interest on the proceeds. The transaction is, in effect, a method for the investment company to invest idle cash for negotiated periods at prevailing market rates. In economic reality and under the definition of the term "lend" in Section 2(a)(23) of the

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Footnotes continued from last page

"The asset and liability relating to a 'when issued' security should be recorded when the priced transaction confirmation is issued, and the investment should be valued thereafter." American Institute of Certified Public Accountants, Statement of Position 79-1: Accounting for Municipal Bond Funds (Proposal to the Financial Accounting Standards Board to Amend AICPA Industry Audit Guide, *Audits of Investment Companies*, January 15, 1979.) Paragraph 20. In a firm commitment, the analogous "priced transaction confirmation" appears to be issued when the commitment is written. The difference between the balance of the asset and liability accounts would be reflected in the company's net asset value. It should be noted that payment for the security, while extinguishing the liability, would not be likely to affect the total value of the company's net assets.

[17] Using this analogy, when a standby commitment is written its only recognition in the accounting records would be an entry to record the premium received as a deferred credit (a liability). The full value of the committed securities would not receive recognition at this time because their acquisition is contingent on interest rate movements during the commitment period. However, in order to compute net asset value properly, any decline in the value of the committed securities should be recognized because it is a measure of an actual liability. Such declines in value should be reflected as increases in the deferred liability account used to record the premium received. Whenever it becomes reasonable to expect that the company will purchase and take into its portfolio the committed securities, it appears appropriate to recognize the value of the committed security as an asset and the full purchase price as a liability with appropriate entries to the deferred liability account in which the premium and unrealized depreciation was recorded. It may also be appropriate to adjust the deferred liability account to the extent of the premium received in response to increases in the market value of the committed securities. Such value increases would be recorded as a decrease in the deferred liability account. Recording increases in the value of committed securities in excess of the premium received appears to be inappropriate because as such value increases the investment company would probably not be asked to perform under the commitment. When the commitment period expires, or at an earlier time if it is reasonably expected that the company will not be expected to perform under the commitment, the amounts relating to the commitment should be removed from the investment company's accounting records and a realized gain or loss recognized, as appropriate. Because all of the accounting consequences will be recognized in terms of gain or loss, commitment premiums should not be recorded as an element of investment income. Financial statements should fully disclose the investment company's potential liability under its commitments.

[18] Such documents would include, but are not limited to, registration statements filed pursuant to Section 8(b) of the Act, reports, filed with the Commission, reports mailed to shareholders pursuant to Section 30 of the Act [15 U.S.C. 80a-29], sales literature distributed to existing and prospective investors under Section 24(b) of the Act [15 U.S.C. 80a-24(b)] and proxy statements filed pursuant to Section 20 of the Act [15 U.S.C. 80a-20].

[19] "The lack of investment quality characterizes the common stock of open-end leverage investment companies as well as that of closed-end leverage investment companies. The contributor to the open-end fund can easily be impressed by the representation that the senior capital is working for him; he can less easily be expected to realize that . . . upon any substantial market oscillation his investment will be virtually impaired or entirely swept away." Senate Hearings at 1044.

[20] Section 35(d) of the Act [15 U.S.C. 80a-34(d)] provides that it is unlawful for an investment company to adopt as part of its name or title any words which the Commission finds, and by order declares, to be deceptive or misleading. Although the types of securities trading practices in question usually involve an underlying security which bears a government guarantee, the agreements and their expected returns do not bear such guarantees. Thus, an investment company which is significantly involved in such securities trading practices, and which uses a name that appears to suggest or allude inappropriately to the existence of a U.S. government guarantee, may be using a deceptive or misleading name within the meaning of Section 35(d) of the Act. In cases where the Division believes a violation may have occurred, the Commission has instructed it to seek appropriate Commission orders and to recommend to the Commission that appropriate action be taken as authorized by Section 35(d) of the Act.

[21] Letter dated March 24, 1978, from the Division of Investment Management to Sidley & Austin re American Medical Association Tax-Exempt Income Fund Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,612.

[22] Section 12(d)(3) of the Act, in part, prohibits an 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, a dealer, [or] is engaged in the business of underwriting."

Act, the repurchase transaction is a loan by the investment company to the selling party secured by the securities transferred to the investment company. Use of repurchase agreements permits investment companies to invest idle cash at negotiated yields for periods as brief as overnight and may improve the overall performance of investment companies. Investors in the market for repurchase agreements appear to be primarily institutional. To deprive investment companies of access to such opportunities may impair the ability of certain investment companies to seek and to offer investment performance as favorable as that available through other institutional investors not subject to such a limitation. Moreover, the legislative history of Section 12(d)(3) suggests that its purpose principally was to prevent investment companies, except pursuant to certain conditions, from exposing their assets to the entrepreneurial risks of an investment banking business, as would be the case where an investment company took a partnership interest in a broker/dealer. Here, however, the investment company as lender would look to the intrinsic value of the collateral (i.e. the Ginnie Mae or other U.S. government security) rather than the creditworthiness or other risks associated solely with the business operations of the broker/dealer.[23] Accordingly, the Division henceforth will not recommend to the Commission that enforcement action be brought under Section 12(d)(3) against investment companies with respect to such transactions if the repurchase agreement is structured in a manner reasonably designed to collateralize fully the investment company loan, i.e., the value of the transferred security is, and during the entire term of the agreement remains, at least equal to the amount of the loan including the accrued interest earned thereon.

The Division remains concerned, however, about the possibility of abuse in such situations, particularly if investment companies enter into repurchase agreements to promote certain reciprocal practices, such as loans to broker/dealers [24] on terms less favorable than those available with other broker/dealers or banks to encourage share distribution efforts or to obtain research services for the investment adviser. Those kinds of reciprocal practices could result in violations of the investment company's and the investment adviser's fiduciary obligations under the Act to investment company shareholders. Therefore, the Commission has instructed the Division to monitor and review carefully investment company activities in this area.

In connection with the Division's present "no-action" position, directors should review their methods of accounting for repurchase agreements. An investment company should not record as an asset the securities which collateralize a loan pursuant to a repurchase agreement. It is also important to disclose the amount of the loan, and the effective interest rate to be received. Furthermore, directors should review the policies articulated in their investment company's registration statement pursuant to Section 8(b) of the Act, regarding, in particular, the making of loans to other persons, to ensure compliance with Sections 8 and 21 of the Act [15 U.S.C. 80a-21].[25]

Conclusion

The Commission believes that, as part of their general fiduciary duties to shareholders, directors should review the securities trading practices of their investment company to determine whether any of the practices which are the subject of this release (or any different practices with analogous effects on the capital structure of the investment company) exist, or are contemplated. If so, directors should make the determinations, inquiries, and disclosures recommended in this release. If necessary and appropriate, directors should consider the creation and maintenance of segregated accounts to ensure compliance with the policies and provisions of Section 18 of the Act.

The Commission has instructed the Division, through its oversight of the Commission's investment company inspection program, to monitor carefully the compliance of investment companies engaging in the aforementioned and similar securities trading practices with the disclosure and regulatory provisions of the Act, and with the appropriate disclosure requirements of the Securities Act of 1933 and Securities Exchange Act of 1934 applicable to investment companies.

Accordingly, Part 271 of Title 17 of the Code of Federal Regulations is amended by adding this General Statement of Policy regarding Securities Trading Practices Of Registered Investment Companies.

The Commission would, of course, welcome the views of directors and other interested persons on any of the matters discussed herein. All views or comments should be submitted in writing to the Securities and Exchange Commission, Washington, D.C. 20549 and refer to File S7-776. All communications will be available for public inspection.

By the Commission.

George A. Fitzsimmons,
Secretary

April 18, 1979.

[Release No. IC-10666, S7-776]
[FR Doc. 79-13007 Filed 04-26-79; 8:45 am]
BILLING CODE 8010-01-M

[23] See Senate Hearings at 243.

[24] Repurchase agreements with broker-dealers affiliated with the investment company would, of course, raise serious questions under Sections 17(a) and 17(d) of the Act [15 U.S.C. 80a-17(a), 17(d)].

[25] Section 21 of the Act provides, in part, that "It shall be unlawful for any registered management company to lend money or property to any person, directly or indirectly, if the investment policies of such registered company . . . do not permit such a loan . . ."