Koenig Tax-Advantaged Liquidity Fund, Inc.

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SECURITIES AND EXCHANGE COMMISSION
RECEIVED
DEC 19 1984
OFFICE OF APPLICATIONS AND REPORT SERVICES

Act ICA-40
Section 18(f)
Rule
Public Availability 3/27/85

December 18, 1984

Re: Koenig Tax-Advantaged Liquidity Fund, Inc.
Investment Company Act of 1940,
Sections 17(f) and 18(f)

Dear Mr. Cimmet:

We are writing to request the advice of the Division that it would not recommend to the Commission that it take action if Koenig Tax-Advantaged Liquidity Fund, Inc. (the "Fund") and F. Martin Koenig & Company, the Fund's investment adviser (the "Adviser") utilize index options and futures, as well as non-index options, futures and bank forward contracts as outlined below.

The Fund

The Fund is a corporation incorporated under the laws of Maryland on August 6, 1982. It is a non-diversified, open-end management investment company registered under the Investment Act of 1940, as amended (the "1940 Act"), and commenced operations in June 1983.

As set forth in Post-effective Amendment No. 3 on Form N-1A to the Fund's Registration Statement (a copy of which is enclosed for your reference), shares of the Fund are offered to corporate investors who desire income which may qualify for the 85% corporate dividends received deduction for Federal income tax purposes.* The Fund's investment objective is to

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* Post-effective Amendment No. 3 was filed with the Commission on October 31, 1984 and is presently in the process of being reviewed by the Commission staff.

earn a high level of total return from dividends, interest and net short-term and long-term realized and unrealized capital gains while preserving capital. The Fund will attempt to achieve its objective primarily by investing in and maintaining a portfolio of common stock equity securities and foreign and domestic fixed income securities (including preferred stock and debt instruments) hedged with various index options and futures as well as non-index options, futures and forward contracts, including over-the-counter options, and those on currencies, fixed income and other financial instruments which are, or in the future may be, traded on Exchanges or over-the-counter.

The Fund is seeking an opinion (or alternatively, a "no-action" letter) from the Commodity Futures Trading Commission ("CFTC") Division of Trading and Markets that the Fund is not a "pool" under Section 4.10(d) of the CFTC's regulations and that neither the Adviser nor the officers, directors or employees of the Adviser or the Fund will be deemed a "commodity pool operator" as defined in Section 2(a)(1)(A) of the Commodities Exchange Act ("CEA").

The Fund's Hedging Strategies

The various hedging strategies to be used by the Fund, subject to receipt of favorable responses from the Commission staff and the CFTC are set forth at pages 24 through 26 of Part A of the enclosed Post-effective Amendment to the Fund's Registration Statement and are briefly summarized below.

Stock Index Futures. A stock index assigns relative values to the stocks included in the index, and the index fluctuates with changes in the market value of the stocks so included. A stock index futures contract is a bilateral agreement pursuant to which the Fund will agree to buy or deliver at settlement an amount of cash equal to a dollar amount multiplied by the difference between the value of a stock index at the close of the last trading day of the contract and the price at which the futures contract is originally struck.

The Fund may sell stock index futures contracts (a "short hedge"), in anticipation of or during a general market price decline to attempt to hedge against the effects of the general market movement on the Fund's securities portfolio. When the Fund is not fully invested in the securities market and anticipates a significant market advance, it may purchase stock index futures (a "long hedge") in order to gain rapid market exposure that may in part or entirely offset increases in the cost of securities that the Fund intends to purchase. In a substantial majority of these transactions, the Fund will purchase long securities upon termination of the long futures purchase, but under unusual market conditions, a long futures position may be terminated without the corresponding purchase of securities. Similarly, in a substantial majority of long hedges in financial futures and foreign currency futures, as well as options on financial futures the Fund will purchase the long security or instruments denominated in such currency upon termination of the long hedge.

Options on Stock Index Futures. The Fund may purchase put options or write call options on stock index futures for the purpose of short hedging the Fund's securities portfolio against an anticipated market-wide price decline. The Fund may also purchase call and write put options on stock index futures as a long hedge against a market movement as well. The Fund may sell or purchase such options to terminate an existing position.

Financial Futures. A financial futures contract sale creates an obligation by the Fund, as seller, to deliver the specific type of financial instrument called for in the contract at a specified future time for a specified price. A futures contract purchase creates an obligation by the Fund, as purchaser, to take delivery of the specific type of financial instrument at a specified future time at a specified price. The specific securities delivered or taken, respectively, at settlement date, are not determined until at or near that date. The determination is in accordance with the rules of the Exchange on which the futures contract sale or purchase was made. The Fund does not intend to take delivery of the instruments underlying futures contracts it holds.

Although financial futures contracts by their terms call for actual delivery or acceptance of securities, in most cases the contracts are closed out before the settlement date without the making or taking of delivery of securities. Closing out a futures contract sale is effected by the Fund entering into a futures contract purchase for the same aggregate amount of the specific type of financial instrument and same delivery date. If the price in the sale exceeds the price in the offsetting purchase, the Fund immediately is paid the difference and thus realizes a gain. If the offsetting purchase price exceeds the sale price, the Fund pays the difference and realizes a loss. Similarly, the closing out of a futures contract purchase is effected by the Fund entering into a futures contract sale. If the offsetting sale price exceeds the purchase price, the Fund realizes a gain, and if the purchase price exceeds the offsetting sale price, the Fund realizes a loss.

The Fund may sell financial futures on U.S. and foreign agency and government securities, GNMA certificates, foreign and domestic bank certificates of deposit and commercial paper and similar instruments traded on domestic and foreign exchanges, as well as over-the-counter, in order to short hedge its portfolio, particularly portfolio securities which may be sensitive to changes in interest rates. The Fund may also purchase financial futures on such instruments as a long hedge.

Options on Financial Futures. The Fund may purchase put and write call options on financial futures in order to short hedge the Fund's portfolio. It may also purchase call and write put options on financial futures as a long hedge.

Foreign Currency Options, Futures and Related Options and Bank Forward Contracts. In an attempt to hedge against currency risk of foreign securities, the Fund may engage in short and long hedging strategies involving the purchasing, writing and selling of options (either listed or over-the-counter from money center banks), futures, options on futures (to the extent they are or will be traded) and forward contracts on five major currencies: the Canadian Dollar, Japanese Yen, British Pound, Swiss Franc, and the German Mark. It is intended that exchange-traded foreign currency option transactions will be executed on the Philadelphia Stock Exchange, and the Fund is not prohibited from trading options listed on other recognized exchanges such as London, Amsterdam and Montreal/Toronto. The effectiveness of these hedging strategies will depend upon the correlation between real interest rates and changes in the value of such currencies. In addition, due to temporary price distortions in the market, a correct forecast of real interest trends by the Adviser may still not result in an effective use of these instruments as a hedge.

The purchase or sale of a futures contract differs from the purchase or sale of a security, in that no price or premium is paid or received. Instead, an amount of cash or U.S. Treasury bills equal to approximately 5% of the contract amount must be deposited with a broker. This amount is known as initial margin. Subsequent payments to and from the broker, called variation margin, are made on a daily basis as the price of the underlying stock index fluctuates making the long and short positions in the futures contract more or less valuable, a process known as mark to the market. At any time prior to expiration of the futures contract, the Fund may elect to close the position by taking an opposite position which will operate to terminate the position in the futures contract. A final determination of variation margin is then made, additional cash is required to be paid to or released by the broker, and the Fund will realize a loss or gain. In addition, the Fund will pay a commission on each contract when it is offset or otherwise liquidated.

Restrictions on Use of Futures and Options on Futures

As mentioned above, the Fund is seeking an opinion, or a no-action letter, from the CFTC with respect to the use of futures and options on futures. In seeking such opinion, the Fund has represented to the CFTC that (1) all of the Fund's futures and options on futures transactions will constitute bona fide hedging transactions within the meaning of such regulations; and (2) the Fund has represented that it may not purchase or sell stock index futures or financial futures or purchase related options if, immediately thereafter, the sum of the amount of initial margin deposits on the Fund's existing futures positions and premiums paid for related options would exceed 5% of the market value of the Fund's total assets. The Fund further represents for purposes of this request that (1) it will not purchase or sell stock index futures or financial futures or purchase related options, if, immediately thereafter, more than one-third of its net assets would be represented by futures contracts or related options; (2) when the Fund establishes a position in a stock index future or financial future, an amount of cash and cash equivalents, equal to the market value of the futures contract (less any margin deposits thereon), will be deposited in a segregated account with the Fund's custodian and/or in a margin account with a broker to collateralize the position and thereby insure that the use of such futures is unleveraged; and (3) when the Fund sells or purchases a bank forward contract, the Fund will set aside in a segregated account with the Fund's custodian the amount of cash and cash equivalents, including high grade marketable securities denominated in the foreign currency to which such bank forward contract relates, necessary to collateralize and meet its obligations under such bank forward contract. The full collateralization of a long futures contract or bank forward contract makes the use of such contracts consistent with reverse repurchase agreements, standby commitments and other similar arrangements discussed in Investment Company Act Release No. 10666 (April 18, 1979) ("Release 10666"). Assets so segregated would not be used by the Fund to support any other transaction in which the Fund may enter. See the Fund's Amendment No. 3, Part B at 5.

Issues Under Sections 18(f) and 17(f)

The Staff of the Commission has, in the past, taken the position that although futures contracts themselves may not be securities, the purchase of a futures contract and the purchaser's ensuing obligation to pay variation margin during the life of the contract may involve the issuance of 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 of a stock index futures or financial futures contract and of a put or call option thereon by the Fund may constitute the issuance of a senior security by the Fund in violation of Section 18(f)(1) of the Act. In addition, to the extent that variation margin payments to the Fund in connection with a stock index or financial futures contract are held overnight by a broker, the Fund may be unable to comply with the provisions of Section 17(f) of the Act.

We believe that stock index, financial futures and bank forward contracts and related options, are not securities for the purpose of the Act, and thus, such contracts cannot constitute "senior securities" under Section 18(g) or be subject to regulation under Section 18(f)(1). Furthermore, even if such contracts are considered to be senior securities under the Act, the proposed use by and limitations on the Fund with respect to such contracts 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 such contracts and the requirement, in connection with the purchase of a stock index, financial futures or bank forward contract, that the Fund deposit in a segregated account cash or cash equivalents equal to the market value of such contract are, in fact, consistent with the procedures set forth in Release 10666 to minimize the speculative aspects of the leveraged investments which were the subject of Release 10666.

In addition, we believe a separate custodian agreement among the Fund, its custodian and the futures commission merchant, pursuant to which the Fund's margin deposits are held by the custodian subject to dispostion by the futures commission merchant in accordance with the CFTC rules and the rules of the applicable commodities exchange, will be consistent with the provisions of Section 17(f).

We note that recently the Staff has concurred with opinions similar to those expressed herein with respect to other registered open-end investment companies that proposed to use stock index and financial futures and related options, see,

<u>Colonial Option Income Trust - Portfolio II</u> (available September 10, 1984); stock index futures and related options, see, <u>Colonial Option Growth Trust</u> (available June 15, 1984); and financial futures and related options, see, <u>Colonial Government Securities Plus Trust</u> (available June 15, 1984), in the manner proposed by the Fund.

Subject to the receipt of the opinion from the CFTC described above, we request on behalf of the Fund and the Adviser to the Fund your advice to the effect that the Division of Investment Management would not recommend enforcement action to the Securities and Exchange Commission under the provisions of Section 18(f)(1) and 17(f) of the Act with respect to the Fund's proposed transactions in stock index, financial futures and bank forward contracts and related options.

The original and seven copies of this letter are enclosed for your convenience. If you have any questions or require any further information regarding the matters addressed in this letter, please telephone the undersigned collect at (212) 422-3812, or Jon Mark, Esq. of Cahill Gordon & Reindel at (212) 701-3100. If for any reason you do not concur with our conclusions set forth herein, we respectfully request that you afford us an opportunity to confer with the staff of the Division prior to the transmittal of an unfavorable written response.

Very truly yours,

KOENIG TAX-ADVANTAGED
LIQUIDITY FUND, INC.

By F. Martin Koenig
F. Martin Koenig

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cc: Jon Mark, Esq.

Koenig Tax-Advantaged Liquidity Fund, Inc.

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(212) 422-3810

January 23, 1985

Re: Koenig Tax-Advantaged Liquidity Fund, Inc. (the "Fund") Investment Company Act of 1940 Sections 17(f) and 18(f)

Dear Mr. Lins:

As discussed with our counsel on the telephone, our no-action request dated December 18, 1984 is supplemented as set forth in this letter.

In connection with the custodianship requirements of Section 17(f) of the Investment Company Act of 1940, as amended, the Fund will enter into arrangements under which, when it buys or sells a stock index future, financial future or options on such investments, there will be created at the Fund's custodian bank an account (the "FCM Account") in the name of the futures commission merchant ("FCM") through which the transaction was effected (unless there is already in existence at the custodian an FCM Account for the FCM in question). Such arrangements may be set forth in custodian agreement between the Fund and the custodian and/or in separate agreements to which the Fund, the custodian and the FCM are parties, but in any event will contain provisions which require that the custodian shall permit access to the assets in an FCM Account only by the FCM, only in the event that the FCM states to the custodian that the Fund is in default of its obligations and that all conditions precedent to the right of the FCM to direct disposition have been satisfied.

In addition, the Fund will (i) at any time when the balance in an FCM Account exceeds the required margin, promptly withdraw the excess; and (ii) when the Fund has the right to receive variation margin payments from an FCM, promptly demand such payments upon notification from the FCM that such amounts are payable and deposit the same with its custodian.

If you require any further information in connection with the request, please contact either the undersigned at (212) 422-3812 or Jon Mark, Esq. at (212) 701-3100.

Very truly yours,

KOENIG TAX-ADVANTAGED
LIQUIDITY FUND, INC.

By F. Martin Koenig
F. Martin Koenig

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cc: Jon Mark, Esq.

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RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 84-454-CC
Koenig Tax-Advantaged
Liquidity Fund, Inc.
File No. 811-3547

We would not recommend enforcement action to the Commission against the Koenig Tax-Advantaged Liquidity Fund, Inc. ("Fund") under sections 17(f) and 18(f) of the Investment Company Act of 1940 if the Fund proceeds in the manner described in your letter of December 18, 1984, as modified by your letter of January 23, 1985. Our position is based on the facts and representations contained in those letters and the additional oral representations made to me on January 30, February 8, February 12, and February 21, 1985, to the effect that:

1) the Fund's activities with respect to the various instruments ("instruments") mentioned in the above-noted letters will be undertaken only as appropriate hedges for its portfolio;

2) if the Fund writes a put option on any instrument, the Fund will acquire another put option on the same instrument at the same price or will deposit in a segregated account (not with a broker) cash or cash equivalents equal to the purchase price of the contract (less margin deposits thereon);

3) if the Fund buys any futures contract or forward contract, the Fund will deposit in a segregated account (not with a broker) cash or cash equivalents equal to the purchase price of the contract (less margin deposits thereon); and,

4) the language in your letter of December 18, 1985, restricting the Fund's purchase and sale of instruments if, immediately thereafter, "more than one-third of its net assets would be represented by futures contracts or related options" is altered to state that the Fund will not engage in these activities if more than one-third of the Fund's net assets would be hedged.

Gerald T. Lins

Gerald T. Lins
Attorney