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1940 Act Section 18(f)

July 1, 1996

VIA FEDERAL EXPRESS

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

Re: Merrill Lynch Asset Management, L.P.  
Investment Company Act of 1940 - Section 18(f)

Dear Mr. Murphy:

We are writing on behalf of Merrill Lynch Asset Management, L.P. ("MLAM"), an investment adviser to a large number of investment companies (each, a "Fund") registered under the Investment Company Act of 1940, as amended (the "Act").<sup>1</sup> We are requesting the assurance of the Staff of the Securities and Exchange Commission (the "Commission") that it will not recommend enforcement action to the Commission under Section 18(f) of the Act against MLAM or any Fund in connection with certain Fund securities trading practices which might otherwise be deemed to create leverage in violation of Section 18(f) (for purposes of this letter, such transactions are referred to as "Senior Security Transactions"). More specifically, we are requesting no-action assurance to permit MLAM to

<sup>1</sup> As of the date hereof, MLAM, together with certain of its affiliates, acts as investment adviser to over one hundred registered investment companies. For purposes of this letter, MLAM and such affiliates are referred to collectively as "MLAM."

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place liquid assets of any type, including equity securities and debt securities of any grade, in segregated accounts established on the books of a Fund's custodian bank to cover its obligations in connection with Senior Security Transactions.<sup>2</sup>

I. Law

Section 18(f) of the Act provides, in relevant part:

It shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer, except that any such registered company shall be permitted to borrow from any bank: **Provided**, that immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company. . . .

In a 1979 release often referred to as "Release 10666," the Commission stated its position that various trading practices might be deemed to be Senior Security Transactions in violation of Section 18(f).<sup>3</sup> The Commission stated that in order to avoid the creation of a senior security (and hence to avoid a violation of Section 18(f)), an investment company may establish a segregated account to eliminate the potential leverage inherent in the Senior

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<sup>2</sup> Each Fund's Prospectus and Statement of Additional Information describes the particular techniques that may be used by that Fund, as well as the percentage and other limitations imposed on the use of such techniques. In certain instances, a Fund that engages in Senior Security Transactions may cover its open position in another manner, for example by owning the instruments underlying a short position, thereby avoiding the need to create a segregated account. See Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,472, at 77,560, 77,565 (June 22, 1987). For purposes of this letter, MLAM is addressing situations in which other methods of covering a Fund's exposure are unavailable and where, therefore, the Fund is required to segregate assets.

<sup>3</sup> Securities Trading Practices of Registered Investment Companies; General Statement of Policy, Investment Company Act Release No. 10666, 6 Fed. Sec. L. Rep (CCH) ¶ 48,525 at 31,553, 31,553-3 (Apr. 18, 1979) (hereinafter, "Release 10666").

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Security Transactions.<sup>4</sup> Release 10666 states 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."<sup>5</sup> In a subsequent no-action letter relating to segregation requirements in the context of Senior Security Transactions, the Staff of the Commission's Division of Investment Management stated that a segregated account should contain "cash or certain liquid assets," without specifying whether such liquid assets may include only U.S. government securities and other high-grade debt obligations, or whether such liquid assets could include equity securities and other debt securities as well.<sup>6</sup> In January 1992, however, in a letter to registrants, the Staff of the Commission took the position that "[e]quity securities cannot be used in segregated accounts."<sup>7</sup> The Staff did not cite any reason for this new restriction.

## II. Discussion

Limiting the categories of assets that can be placed in a segregated account to cash and high-grade debt securities distorts the economics of Senior Security Transactions for certain types of Funds. MLAM believes that this distortion is unintended; that it increases costs for shareholders of such Funds while providing no additional safety or other countervailing benefit; and that it can be eliminated without undermining the principles articulated in Release 10666.

The differing effect of current segregation requirements on a high-grade debt fund and an equity fund engaged in similar portfolio management strategies is illustrated by a hypothetical example set forth in Appendix A to this letter. In summary, if a high-grade debt fund and an equity fund each desire to engage in similar hedging strategies involving Senior Security Transactions, the debt fund can proceed by segregating assets in which it would ordinarily invest, consistent with its investment objectives, while the equity fund would have to meet its segregation requirements by replacing equity securities held as portfolio investments

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<sup>4</sup> *Id.* at 31,553-8.

<sup>5</sup> *Id.* (emphasis added).

<sup>6</sup> *Dreyfus Strategic Investing, supra* n. 2, at 77,565.

<sup>7</sup> Preparation of Disclosure Filings by Investment Company Registrants, [1993-1995 Transfer Binder] Mutual Funds Guide (CCH) § 13,253, at 23,221, 23,224 (Jan. 17, 1992).

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with high-grade debt obligations, which could make the hedging strategy financially unattractive.

MLAM believes that the purposes of the segregation requirement, as articulated by the Commission in Release 10666, can be as well served by the segregation of liquid equity securities or liquid debt securities of any grade as by the segregation of liquid high-grade debt securities. Such a policy would eliminate the economic distortion which results from the current interpretation of Release 10666, and which is illustrated by the hypothetical example in Appendix A. In Release 10666, the Commission stated that "[a] segregated account freezes certain assets of the investment company and renders such assets unavailable for sale or other disposition."<sup>8</sup> The purposes of the segregated account, in the Commission's view, are twofold. First, the segregation requirement "function[s] 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." Second, "such accounts will assure the availability of adequate funds to meet the obligations arising from such activities."<sup>9</sup>

Regarding the first purpose set forth above, the amount of leverage that a Fund can assume will be equally limited regardless of the type of asset placed in the segregated account, so long as that asset is not itself of the type that would require the creation of a segregated account (e.g., a "when-issued" security). Similarly, the other function of the segregated account, the assurance of the availability of adequate funds, will be satisfied so long as a sufficient amount of liquid assets is maintained in the segregated account. The requirement under Release 10666 that the segregated account be marked to market daily is designed as a safeguard for this purpose.

Accordingly, MLAM proposes that the Funds be permitted to use liquid assets of any type, including equity securities and debt securities of any grade, to satisfy segregated account requirements in connection with Senior Security Transactions so long as the securities segregated are "liquid" as that term is commonly understood under the Act.<sup>10</sup>

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<sup>8</sup> Release 10666, *supra* n. 3, at 37,553-8.

<sup>9</sup> *Id.*

<sup>10</sup> Guide 4 to Form N-1A provides, in relevant part, that an illiquid security "is any asset which may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment."

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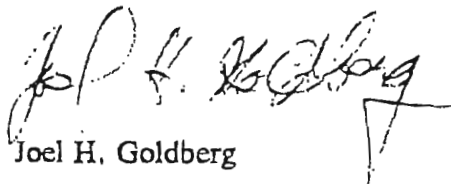
III. Conclusion

MLAM believes that segregating assets other than cash, U.S. government securities or high-grade debt securities in fulfillment of the segregation requirement in connection with Senior Security Transactions is consistent with both the literal terms and the underlying policy of Release 10666. More specifically, MLAM believes that the requirements and purpose of Release 10666 would be met by allowing a Fund to place a wider range of securities in its segregated account, so long as those securities are "liquid" as that term is used under the Act.

This approach would eliminate the adverse effect upon investors caused by the economic distortions that can result for certain types of Funds if permissible assets for segregated accounts are limited to cash, U.S. government securities and high-grade debt securities. Accordingly, MLAM respectfully requests the assurance of the Staff of the Commission that it will not recommend enforcement action to the Commission under Section 18(f) of the Act against MLAM or any Fund if MLAM places liquid equity or debt securities in segregated accounts.

If you have any questions, please telephone the undersigned at (212) 891-9359 or Judith L. Shandling at (212) 891-9459.

Very truly yours,

  
Joel H. Goldberg

cc: Ira P. Shapiro, Esq.  
Jerry Weiss, Esq.

APPENDIX A

Assume two Funds -- an equity Fund and a high-grade debt Fund. Each Fund is authorized to engage in various Senior Security Transactions (consistent with the limitations in Release 10666). Assume further that in keeping with its investment objectives each Fund has invested 95% of its assets in accordance with its investment objectives and has invested the remaining 5% of its assets in short-term U.S. Treasury securities and U.S. dollar-denominated high-grade commercial paper for cash management purposes.

For purposes of the hypothetical, assume that (i) each Fund has net assets of \$2 billion, (ii) each Fund can generally expect an annualized return of 5% on short-term cash equivalent investments and an aggregate annualized return of 9% on its entire remaining portfolio of other investments and (iii) the equity Fund's investment policies do not permit it to purchase long-term debt securities. Assume that the debt Fund wishes to protect its asset value from an anticipated rise in interest rates, while the equity Fund wishes to protect its asset value from an anticipated decline in U.S. large capitalization stocks (which would negatively affect a portion of its portfolio). Accordingly, the debt Fund sells interest rate futures contracts expiring in sixty days and equivalent to \$200 million at current market values. The equity Fund sells S&P 500 futures contracts, also expiring in sixty days and equivalent to \$200 million at current market values. Both of these transactions are Senior Security Transactions, and therefore under the principles enunciated in Release 10666 each Fund must segregate the equivalent of U.S. \$200 million, representing its obligation on the respective futures positions.

If only cash or liquid high-grade debt securities satisfy the segregated account requirements of Release 10666, each Fund can segregate the 5% of its assets currently held in short-term debt instruments (U.S. \$50 million). The remainder of the high-grade debt Fund's portfolio, or U.S. \$1.95 billion, would be available to satisfy the U.S. \$150 million shortfall in the segregated account, without any impact on the debt Fund's investment returns. The equity Fund, however, does not hold any additional high-grade debt securities. It therefore would have to substitute short-term cash equivalent investments for U.S. \$150 million of its equity holdings in order to meet the segregation requirement. This would result in a projected drop in investment return for the equity Fund, as the return on the U.S. \$150 million in cash equivalents will be less than the anticipated return on the (small capitalization or foreign) equity securities that were liquidated to raise money for the purchase of the cash equivalents by approximately U.S. \$1 million. This represents the difference between a 5% annualized return on short-term cash equivalent securities over sixty days and a 9% projected annualized return on equity securities over the same period.

**PUBLIC**

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Our Ref. No. 96-327-CC  
Merrill Lynch Asset  
Management, L.P.  
File No. 801-11583

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

By letter dated July 1, 1996, you seek assurance that the staff would not recommend enforcement action to the Commission under Section 18(f) of the Investment Company Act of 1940 (the "Investment Company Act") against Merrill Lynch Asset Management, L.P. ("MLAM"), or any registered investment company advised by MLAM (a "Fund"), if any Fund "covers" its obligations under certain trading practices by placing liquid assets, including equity securities and debt securities of any grade, in a segregated account established on the books of the Fund's custodian bank.

You state that as of the date of your letter, MLAM, together with certain of its affiliates, acts as investment adviser to over one hundred registered investment companies.<sup>1</sup> You state that the Funds engage in a variety of transactions that may be deemed to create leverage ("Senior Security Transactions"). To avoid the creation of a senior security, and thus to avoid a violation of Section 18(f), a Fund may establish a segregated account to limit the amount of potential leverage inherent in the Senior Securities Transactions, in accordance with positions previously taken by the Commission and the staff.<sup>2</sup>

In Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 ("Release 10666"), published in 1979, the Commission stated that assets placed in segregated accounts should be liquid. By way of example, the Commission listed cash, U.S. government securities, and other appropriate high-grade debt obligations. You state that in certain letters addressing segregation requirements since 1979, however, the staff has read Release 10666 narrowly, and has restricted the assets that may be included in a segregated account to the examples listed in the

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<sup>1</sup> For purposes of this letter, MLAM and its affiliates are referred to collectively as "MLAM."

<sup>2</sup> See, e.g., Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 (Apr. 18, 1979). We note that, in certain instances, a Fund may use other means to cover its Senior Security Transactions, thereby avoiding the need to create a segregated account. See, e.g., Dreyfus Strategic Investing and Dreyfus Strategic Income (pub. avail. June 22, 1987) ("Dreyfus"). You state that your letter addresses situations in which a Fund is unable to use other means to cover its Senior Security Transactions, and therefore is required to segregate assets.

release.<sup>3</sup> You maintain that this narrow reading of Release 10666 increases costs for Fund shareholders, but provides no additional safety or other countervailing benefit.

You maintain that a narrow reading of the segregated account requirement distorts the economics of fund portfolio management and serves to discourage many funds from entering into Senior Security Transactions to hedge their portfolios. As an example, you point out that if a fund investing principally in high grade debt instruments wishes to protect its asset value from a rise in interest rates, it may do so by taking a short position in interest rate futures contracts. Since the fund already holds high grade debt securities, it can easily comply with a narrow reading of Release 10666 by segregating a portion of its assets equal to the amount of its obligation under the contracts. If a fund investing principally in equity securities wishes to protect its asset value from a broad decline in the stock market, the fund can do so by taking a short position in S&P 500 futures contracts. Assuming, however, that the equity fund is invested in accordance with its investment objectives, it likely does not hold sufficient cash and high grade debt securities to meet the segregation requirements under a narrow reading of Release 10666. Therefore, in order to cover its obligation, the equity fund would have to sell its equity securities and either hold cash or purchase high grade debt instruments to place in a segregated account. You maintain that the necessity of doing this discourages many equity funds from entering into Senior Security Transactions to hedge their market exposure, in many cases leaving the fund unhedged.

You propose that the Funds be permitted to place any securities in a segregated account, including equity securities and non-investment grade debt securities, so long as the securities are liquid. You believe that the purposes of the segregation requirement are served as well by the segregation of liquid equity securities or liquid debt securities of any grade, as by the segregation of cash, U.S. government securities, and high-grade debt obligations. You maintain that permitting any liquid security to be segregated would eliminate the economic distortion which results from a narrow reading of Release 10666.

### Analysis

Section 18(f)(1) of the Investment Company Act generally prohibits a registered open-end investment company from issuing

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<sup>3</sup> E.g., Letter to Registrants from Carolyn B. Lewis, Assistant Director, Division of Investment Management (Jan. 17, 1992).



any senior security,<sup>4</sup> except that such an investment company may borrow from a bank if the investment company has asset coverage of at least 300%.<sup>5</sup> In Release 10666, the Commission described certain types of portfolio transactions that involve leverage and therefore could be deemed to create senior securities if engaged in by a fund. The Commission stated, however, that the issue of compliance with Section 18 would not be raised if a fund covers its obligations under these portfolio transactions by maintaining a segregated account on the books of its custodian bank<sup>6</sup> containing assets equal in value to those obligations.<sup>7</sup> The assets in a segregated account must be otherwise unencumbered,<sup>8</sup> and must be liquid and marked to the market daily. Additional assets must be placed in the segregated account whenever the

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<sup>4</sup> Section 18(g) defines "senior security," in relevant part, as

any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness . . . .

<sup>5</sup> Section 18(f)(1) provides, in relevant part, that

[i]t shall be unlawful for any registered open-end company to issue any class of senior security or to sell any senior security of which it is the issuer, except that any such registered company shall be permitted to borrow from any bank: *Provided*, that immediately after any such borrowing there is an asset coverage of at least 300 per centum for all borrowings of such registered company. . . .

<sup>6</sup> Segregated assets do not need to be physically segregated. It is sufficient, for purposes of this requirement, if the fund's custodian notes on its books that the assets in question are "segregated." Segregated assets may not be used to cover other obligations, and, if disposed of, must be replaced.

<sup>7</sup> In certain instances a fund may also cover senior securities by holding or having the right to obtain the property that the fund has obligated itself to deliver, and thus eliminate the need to segregate assets. See, e.g., Dreyfus.

<sup>8</sup> See, e.g., Release 10666; Pension Hedge Fund Inc. (pub. avail. Jan. 20, 1984) (assets included in a segregated account will collateralize no other transaction).

total value of the account falls below the amount of the fund's obligations under the Senior Security Transactions.<sup>9</sup>

The purposes behind the segregated account requirement are twofold. First, requiring the maintenance of a segregated account places a practical limit on the amount of leverage that a fund may undertake and on the potential increase in the speculative character of its outstanding shares. Second, the accounts assure the availability of adequate funds to meet the obligations arising from the transactions in which leverage is created.<sup>10</sup>

Regarding the first purpose set forth above, the type of asset placed in the segregated account would have no effect on the maximum amount of leverage that a fund can assume. Similarly, the second purpose of the segregated account -- the assurance of the availability of adequate funds -- will be satisfied so long as only liquid assets are maintained in the segregated account, and the value of those assets is marked to the market daily.

We believe that it would be consistent with the language and policy of Section 18(f) and Release 10666 to permit a Fund to place any asset, including equity securities and non-investment grade debt, in a segregated account, so long as the asset is liquid and marked to the market daily.<sup>11</sup> Ultimate oversight responsibility for determining liquidity resides with the fund's board of directors.<sup>12</sup> The board may delegate the day-to-day functions of determining and monitoring liquidity to the

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<sup>9</sup> See, e.g., Release 10666; Dreyfus. The value of the assets a fund is required to maintain in a segregated account may, in certain circumstances, be reduced by the value of certain collateral deposited with the senior security counterparty. E.g., Robertson Stephens Investment Trust (pub. avail. Aug. 24, 1995); Dreyfus.

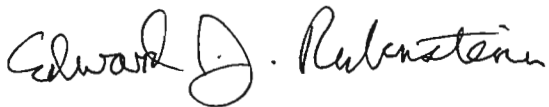
<sup>10</sup> Release 10666.

<sup>11</sup> We note that a fund's compliance responsibilities with respect to marking assets in a segregated account to the market daily may require greater vigilance if securities in the account are subject to a higher degree of price volatility than cash, U.S. government securities and high-grade debt obligations.

<sup>12</sup> Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986) ("Release 14983"); Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994).

investment adviser, provided the board establishes guidelines and procedures, and oversees the adviser's performance of the functions on an ongoing basis. The board, or its delegate, has a continuing duty to monitor the liquidity of segregated account assets, and must take appropriate steps if circumstances change.<sup>13</sup>

Accordingly, we would not recommend that the Commission commence enforcement action under Section 18 of the Investment Company Act if a Fund covers its obligations that may otherwise be deemed to be senior securities by maintaining a segregated account on the books of its custodian, and includes in that segregated account cash or liquid securities (regardless of type) having an aggregate value, measured on a daily basis, at least equal to the amount of the covered obligations. Because this response is based on the facts and representations in your letter, you should note that different facts or representations may require a different conclusion.



Edward J. Rubenstein  
Senior Counsel

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<sup>13</sup> E.g., Resale of Restricted Securities; Changes to Methods of Determining Holding Period of Restricted Securities Under Rule 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990), and Release 14983. See also Letter to Catherine L. Heron, Investment Company Institute, from Carolyn B. Lewis, Assistant Director, Division of Investment Management (June 21, 1991).