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Thomas S. Harman, Esq.
Chief Counsel
Division of Investment Management
Securities and Exchange Commission
Judiciary Plaza
450 Fifth Street, N.W.
Washington, D.C. 20549

Re: No-Action Request of Sanford C. Bernstein Fund, Inc. - Investment Company Act of 1940: Section 18(f)

Dear Mr. Harman:

This letter is submitted on behalf of Sanford C. Bernstein Fund, Inc. (the "Fund"), a Maryland corporation, and its five series of shares, each of which represents an interest in a separate portfolio of securities: Bernstein Government Short Duration, Bernstein Short Duration Plus, Bernstein New York Municipal, Bernstein Diversified Municipal and Bernstein Intermediate Duration. On May 8, 1990, the Fund filed a Post-Effective Amendment, to become effective 60 days after filing pursuant to Rule 485(a) under the Securities Act of 1933, the purpose of which was to add an additional series, the California Municipal Portfolio. Each of the six series is hereinafter referred to as a "Portfolio." The Fund is registered with the Securities and Exchange Commission (the "Commission") under a currently effective registration statement on Form N-1A (No. 33-21844), as an open-end management investment company.

Each Portfolio uses certain investment techniques, among which are writing covered options on securities and writing covered options on financial futures contracts ("futures contracts"). Each Portfolio may write straddles, including straddles which consist of a combination of a put option and a call option on the same underlying security or on a futures contract on the same underlying asset. The Fund is seeking the advice of the staff of the Division of Investment Management (the "Staff") that the Staff will not recommend that the Commission take enforcement action against the Fund or the Portfolios under Section 18(f) of the Investment Company Act of 1940, if the Portfolios use liquid assets (cash, U.S. government securities, other liquid high-grade debt obligations, or the underlying asset itself if it is a liquid high-grade debt obligation) (hereinafter "qualifying assets") to cover both components of those straddles which consist of a combination of a put option and a call option on the same underlying security or on a futures contract on the same underlying asset where the exercise dates of the put and the call are the same and the exercise prices of the call and the put are the same or the exercise price of the call is above that of the put ("qualifying straddles"), as set forth below.

I. Writing Covered Straddles on Securities

A. Puts, Calls and Straddles

As described in the Fund's prospectus, each Portfolio may write (i.e., sell) covered put and call options. By writing a call option, a Portfolio becomes obligated during the term of the option to deliver the underlying securities, upon exercise of the option, to the purchaser of the option at the exercise price. By writing a put option, a Portfolio becomes obligated during the term of the option to purchase the underlying securities from the option purchaser, upon exercise of the option, at the exercise price. Each Portfolio may write covered straddles on its portfolio securities, including straddles consisting, each, of a call and a put written on the same underlying securities. As described in the Fund's prospectus, no Portfolio will write any option if, immediately thereafter, the aggregate value of the Portfolio's securities subject to outstanding options would exceed 25% of its net assets.

B. Cover

As required by Section 18(f) of the Investment Company Act of 1940, to avoid issuing a senior security, the Portfolios write only "covered" options.[1] This means that so long as a Portfolio is obligated as the writer of a call option, it will (i) own the securities subject to the option, (ii) have an absolute and immediate right to acquire those securities without additional cash consideration upon conversion or exchange of other securities held in its portfolio, (iii) hold a call option on the same security with an exercise price no higher than the exercise price of the call sold or, if higher, deposit and maintain the differential in cash, U.S. government securities or other liquid high-grade debt obligations ("liquid assets") in a segregated account with its Custodian; or (iv) deposit and maintain with its Custodian in a segregated account liquid assets having a value that equals the market value of the instruments underlying the call, less any margin on deposit with, or in a segregated account for the benefit of, the Futures Commission Merchant ("FCM") or broker. A put option written by a Portfolio is considered "covered" if, so long as it is obligated as the writer of a put, the Portfolio (i) deposits and maintains with its Custodian in a segregated account liquid assets having a value equal to or greater than the exercise price of the option, less any margin on deposit with, or in a segregated account for the benefit of, the FCM or broker (ii) holds a put on the same security with an exercise price no lower than the exercise price of the put sold or, if lower, the Portfolio deposits and maintains the differential in liquid assets in a segregated account with its Custodian.

The Fund's prospectus currently provides that straddles will be deemed covered when sufficient assets are deposited to meet the requirements as set forth above for each component of the straddle considered separately. Management of the Fund believes that the purposes of the cover requirements would be equally well served and that no senior security should be viewed as resulting if qualifying assets would be placed in a segregated account with its Custodian and used to "cover" both components of qualifying straddles on securities. If the Staff concurs, in such cases the Portfolios will segregate qualifying assets equivalent to the market price of the underlying security, and will also segregate qualifying assets equivalent to the amount,

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1/ The concept of covering a transaction so as to avoid issuing a senior security is discussed at greater length under Section III below.

if any, by which the put is "in-the-money."[2] When the relevant Portfolio covers a qualifying straddle with a qualifying asset that is the underlying asset itself, (1) the Fund's Custodian will earmark that asset in an appropriate fashion in order to ensure that it is not available for other investment purposes while covering the qualifying straddle and (2) the relevant Portfolio will at all times have asset coverage of at least 300% for the combined value of these qualifying assets and any senior securities (i.e., bank borrowings) the Portfolio may have outstanding. In addition, whenever either component of a qualifying straddle is exercised, the relevant Portfolio will either close out the remaining component of the straddle or provide adequate cover for the remaining component in accordance with previous Staff positions.

II. Writing Covered Straddles on Options on Futures

A. Futures

The Portfolios may purchase or sell futures contracts and options thereon. Financial futures are commodity futures contracts which obligate the buyer to take and the seller to make delivery at a future date of a specified quantity of a financial instrument or an amount of cash based on the value of a securities index or the market value in U.S. dollars of a foreign currency.

In connection with transactions in futures contracts and related options, a Portfolio is required to deposit with its Custodian in a segregated account in the name of its FCM as "initial margin" a specified amount of cash and/or short-term U.S. government securities. Thereafter, subsequent payments (referred to as "variation margin") are made to and from the FCM to reflect changes in the value of the futures contracts or short (i.e. written) option positions.

As described in the Fund's prospectus, none of the Portfolios will purchase or sell futures contracts or related options, if, as a result, the sum of the initial margin deposits on a Portfolio's existing futures positions and premiums paid for options on futures contracts exceeds 5% of that Portfolio's total assets, after taking into account unrealized profits and

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2/ The economic effect of this is discussed further below.

unrealized losses on any such contracts it has entered into; provided, however, that in the case of an option that is in-the-money at the time of the purchase the in-the-money portion of the premium is excluded in calculating the 5% limitation.

B. Options on Futures

Unlike a futures contract, which requires the parties to buy and sell a financial instrument on an agreed date, an option on a futures contract entitles its holder to decide on or before a future date whether to enter into such a contract. If the holder decides not to exercise its option, the holder may sell the option or may decide to let the option expire and forfeit the premium thereon.

The purchaser of an option on a futures contract makes no daily payments of cash in the nature of "variation" margin payments to reflect the change in the value of the underlying contract as does a purchaser or seller of a futures contract. The value of the option changes and is thus reflected in the net asset value of the Portfolio. Amounts equal to the initial margin and variation margin on any options on futures contracts sold by the Fund are paid by the Fund directly to the FCM or placed in a segregated account, in the name of the FCM, as required by the Investment Company Act of 1940 and the Securities and Exchange Commission interpretations thereunder.

The Portfolios may write covered straddles on options of futures, including straddles consisting, each, of a combination of a call and a put written on futures contracts on the same underlying asset.

C. Cover

A Portfolio may write (i.e., sell) only covered put and call options on futures contracts. This means that, in the case of a call, the Portfolio (i) owns a long position in the underlying futures contract; (ii) segregates and maintains with its Custodian qualifying assets equal in value to the exercise price of the call (less any initial margin deposited with, or in a segregated account with its Custodian in the name of, the FCM or broker); (iii) owns a security which is deliverable under the futures contract; or (iv) owns a call option on a security which is deliverable under the futures contract or owns a call option on the underlying futures contract, in each case at a price no higher than the exercise price of the call option written by the Portfolio, or if higher, the Portfolio deposits and maintains the differential between the two exercise prices in qualifying assets in a segregated account with its Custodian. A put option on a futures contract written by a Portfolio is considered "covered" if the Portfolio (i) segregates and maintains with its Custodian qualifying assets equal in value to the exercise price of the put (less any initial and variation margin deposited with, or in a segregated account with its Custodian in the name of, the FCM or broker); (ii) owns a put option on the security which is the subject of the futures contract or owns a put option on the futures contract underlying the option, in each case at an exercise price as high or higher than the price of the contract sold by the Portfolio or, if lower, the Portfolio deposits and maintains the differential between the two exercise prices in qualifying assets in a segregated account with its Custodian; or (iii) owns a short position in the underlying futures contract.[3]

The Fund's prospectus currently provides that a straddle on options on futures will be covered when sufficient assets are deposited to meet the requirements as set forth above to cover each component of the straddle considered separately. Management of the Fund believes that the purposes of the cover requirements would be equally well served and that no senior security should be viewed as resulting if qualifying assets equivalent to the market price of the underlying asset less any margin on deposit with, or in a segregated account with its Custodian in the name of, the FCM or broker and qualifying assets equivalent to the amount, if any, by which the put is "in-the-money" would be placed in a segregated account with the Fund's Custodian and used to cover both components of qualifying straddles on futures. When the relevant Portfolio covers a qualifying straddle by using a segregated account, such an account would be maintained, as required by previous Staff positions, with the Fund's Custodian, and not with any FCM or broker. When the relevant Portfolio covers a qualifying straddle with a qualifying asset that is the underlying asset itself, the Fund's Custodian will earmark that asset in an appropriate fashion. In addition, whenever either component of a qualifying straddle on futures is exercised, the Portfolio would either close out the remaining component of the straddle or provide adequate cover for the remaining component.

3/ Initial margin, variation margin, and any daily settlement due as mark-to-market payments on short options on futures will be maintained in accordance with previous staff positions. <u>See</u>, <u>e.g.</u>, Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Goldman, Sachs & Co. (pub. avail. May 2, 1986).

III. Legal Background: Section 18(f) - Commission Releases and Staff No-Action Positions

Section 18(f) 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. . . .

Section 2(a)(36) defines security as

> any note, stock, treasury stock, bond, debenture, evidence of indebtedness . . . any put, call, straddle, option, or privilege on any security . . . or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into on a national securities exchange relating to foreign currency or, in general, any interest or instrument commonly known as a "security."

Finally, Section 18(g) states that, unless otherwise provided: "'Senior Security' means any bond, debenture, note or similar obligation or instrument constituting a security and evidencing indebtedness. . . ."

In Investment Company Act Release No. 7221 (June 9, 1972) the Staff indicated that the sale of put or call options by an open-end company would be permissible if the options were covered. With respect to futures and options on futures, however, Release 7221 indicated that "commodities and commodities contracts," (presumably including options on futures, which did not exist then) would only be permissible within the 300% asset coverage restriction applied by Section 18(f) to borrowings from banks, the only type of senior security open-end funds are permitted to issue.

In Investment Company Act Release No. 10666 (April 18, 1979), the Commission announced a statement of policy regarding three types of trading practices: the reverse repurchase agreement, the firm commitment agreement and the standby commitment agreement. The Release stated that, because these practices enhanced the leverage of a fund's portfolio "[s]uch practices might 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." The Release set forth procedures for covering such transactions with a segregated account so as to avoid the issuance of senior securities. The Release stated that the segregated account specified would prevent leverage, and "will ensure the availability of adequate funds to meet the obligations arising from" certain activities, including entering into a standby commitment agreement, which the Release described as involving, in economic reality, the sale of a put. Thus, in order to cover a standby commitment, a fund would be required by Release 10666 to maintain in a segregated account "liquid assets equal in value to the purchase price under the standby commitment agreement." The Release went on to state that, although the Commission was expressing its views only with regard to those securities trading practices under discussion, "if an investment company were to issue a security which affected its capital structure in a manner analogous to the agreements discussed [in the release] and barring other material differences, the Commission believes it would view the transaction from a similar analytical posture."

In a no-action letter issued to DataConcepts Fund, Inc. (pub. avail. August 25, 1980), the Staff responded to a fund's proposal to write covered call options, and then, if the price of the underlying securities fell, to write additional uncovered call options on the same security. Although the fund stated that it would enter into closing purchase transactions (purchasing call options of the same series as those it had sold) or purchase additional shares of the underlying stock so that any series of call options sold by it would be covered at all times when the exercise price would be less than or equal to the market price of the stock, and, when consequently, there was a reasonable likelihood that such options would be exercised, the Staff declined to issue a no-action position. The Staff stated that while "this strategy, if successful, would limit the Fund's losses to the difference between the premium income received on the writing of an option and, for instance, the cost of a closing purchase transaction," yet, in the case of a rapid rise in the value of the underlying security, the fund might not be able to adjust its portfolio and might suffer substantial losses.

In subsequent no-action letters the Staff outlined the procedures for covering, whether by segregating cash or other liquid assets or by other methods, types of transactions including the sale of options, which, like those discussed in Release No. 10666, otherwise would involve leverage, and hence raise issues under Section 18(f) of the Investment Company Act.[4]

In a no-action letter addressed to Dreyfus Strategic Investing (pub. avail. Jun. 22, 1987) (the "Dreyfus letter") the Staff outlined in detail the various ways in which transactions such as the sale of options, futures and options on futures, which would otherwise raise issues under Section 18(f), could be covered, and made it clear that a covered position need not also comply with the 300% asset coverage restriction set forth in Release 7221.

The Fund has been orally informed by the Staff that the Dreyfus letter is not intended to specify the exclusive means of covering such transactions, but is only intended to provide examples. Accordingly, the Portfolios propose to use some forms of cover which fulfill the requirements set forth in Release 10666, and provide the same protection to the Portfolios as methods specified in the Dreyfus letter.

IV. Discussion

Each of the methods of cover specified in the Fund's prospectus and set forth above, satisfies the requirements of Release 10666 and subsequent no-action positions, that cover be sufficient to satisfy the writer's obligation if the option is exercised. As we shall demonstrate below, the components of the straddle consisting of a put and a call on the same security at the same exercise price are linked in such a way that the same qualifying assets and the amount, if any, by which the put is in the money will meet a Portfolio's obligations under each component of a qualifying straddle, regardless of the order in which the components are exercised, and even if the components are exercised simultaneously.

4/ See, e.g., Prudential-Bache IncomeVertible Plus Fund, Inc. (pub. avail. Nov. 20, 1985); Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Continental Option Income Plus Fund (pub. avail. Aug. 12, 1985); Pilot Fund, Inc. (pub. avail. Sept. 14, 1984); Pension Hedge Fund, Inc. (pub. avail. Jan. 20, 1984); SteinRoe Bond Fund, Inc. (pub. avail. Jan. 17, 1984).

As described above, a Portfolio which writes an option becomes obligated to buy or sell the security (or enter into a futures contract to buy or sell the security) at a specified price if the option is exercised. If a call option is exercised, the Portfolio will be required to deliver the security and will receive the exercise price. If the put option is exercised, the Portfolio will be required to pay the exercise price and will receive the security. Since, in qualifying straddles, the exercise price of the call is the same or higher than that of the put, the price received if the call is exercised is at least as great as the amount that would be required to be delivered on exercise of the put. Similarly, since both options are written on the same security, the security received if the put is exercised is the same security that would be required to be delivered on exercise of the call. Thus, the exercise of the put will automatically provide cover for the call or the exercise of the call will automatically provide cover for the put.

Accordingly, the Fund represents that a Portfolio writing a qualifying straddle will proceed as follows: Qualifying assets equivalent in market value to the market value of the security underlying the straddle, less any margin on deposit with, or in another segregated account with its Custodian in the name of, the FCM or broker, will be placed in a segregated account with the Fund's Custodian and marked-to-market daily. If the put option is exercised first, the proceeds received for the security on settlement (i.e., the security) will be placed in the segregated account to serve as cover for the outstanding call.[5]

5/ The text describes the situation where exercise of the put or call results in settlement by physical delivery of the underlying instrument. It is also possible in some cases that exercise would result in cash settlement (e.g., options on Municipal Bond Index futures involve cash settlement). In the latter case, the writer of a call would settle by paying the difference between the exercise price of the call and the market price of the underlying instrument. The writer of a put would settle by paying the difference between the exercise price of the put and the market price of the underlying instrument. The Fund represents that a Portfolio that writes a qualifying straddle would segregate qualifying assets equal to the market value of the underlying instrument plus any amount by which the put is in the money. The Portfolio therefore would have segrated qualifying assets in an amount sufficient to meet its obligaions with respect to a written
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If the call option is exercised first, the proceeds received for the security on settlement (i.e., cash) will be placed in the segregated account to serve as cover for the outstanding put. Alternatively, upon exercise of one component of the straddle, the relevant Portfolio will either (i) otherwise provide cover for the remaining component of the straddle or (ii) close out the remaining component of the straddle. Upon settlement of either component of a qualifying straddle, the relevant Portfolio will provide cover for the other component on the same day. Qualifying assets in the segregated account will continue to be marked to market after the Portfolio receives notice of the exercise of, or assignment of an exercise notice with regard to, one component of the straddle, until the settlement date for that component. With regard to options on futures, under current procedures, settlement would generally occur on the same day that notification of the assignment of an exercise notice is received.

When a Portfolio writes covered straddles as described above, in contrast to the arrangement proposed in DataConcepts Fund, Inc., discussed above, there is no need for the Portfolio to adjust its investment structure to ensure that each component of the straddle is covered. The relationship between the put and the call in a qualifying straddle is such that the exercise of one automatically provides cover for the other.

In the unlikely event that both components of a qualifying straddle were exercised on the same day, the economic effect would be the same as if an option had been exercised which had been covered by an option on the same security at the same exercise price. As discussed above, Release No. 7221 and subsequent no-action correspondence provide that a call option on a security written by a fund is covered if the fund holds a call option on the same security at an exercise price no higher than the exercise price of the call sold. If the written call option is exercised, the fund is economically protected in that it may subsequently exercise the call option it holds, and thereby receive the security which it was required to deliver under the written call option. Similarly, a put option written by a fund is covered if the fund holds a put option on the same security at an exercise price as high or higher than the exercise price of the written put option. If the written put option is exercised,

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call or a written put that makes up a qualifying straddle or both even if the options are settled in cash.

the fund may subsequently exercise the put option it holds and therefore receive at least the exercise price it was required to pay under the written put option. In each case, the settlement of the option held by a fund would provide assets sufficient to economically protect the fund under the option it had written. Similarly, if both components of a qualifying straddle were to be exercised on the same day, the settlement of one component of the straddle would provide assets sufficient to satisfy the Portfolio's obligations under the other. (Of course, if one component of the straddle was closed out, e.g. by the purchase of another option on the same security at the same expiration date and exercise price, the qualifying assets could then provide cover for the remaining component of the straddle as permitted in the Dreyfus letter.)

It is unlikely that both sides of a covered qualifying straddle would be exercised simultaneously, because the purchaser of an option, whether a put or a call and whether on a security or on a futures contract, will not generally exercise the option unless it is economically desirable to do so, that is, unless the option is "in-the-money." A call option on a security, for instance, is in-the-money if the market price of the security is greater than the exercise price. Similarly, a put option on a security is in-the-money if the market price of the security is less than the exercise price. In qualifying straddles, the market price of the security can never be greater than the exercise price of the call and less than the exercise price of the put at the same time. Thus, the put and the call can never be in-the-money at the same time.[6] Thus, in a qualifying straddle, it may either be advantageous for the holder of the call to exercise the call, or for the holder of the put to exercise the put, but both options will never be profitably exercisable at the same time.

V. Conclusion

Management of the Fund believes that in light of the relationship outlined above between the two components of a qualifying straddle, the Staff's concerns under Section 18(f)

6/ However, even if an option were to be exercised when it was not in-the-money, due to a miscalculation, or, in the case of a call, a shortage of supply in the underlying security which was not fully reflected in the market, the analysis set forth above would still apply.

would be equally well served by the use of the same qualifying assets to cover both the put and the call as by requiring each component to be covered separately, and that no senior security should be viewed as resulting if the Portfolios proceed as set forth above. The Fund and the Portfolios respectfully request your advice that the Staff would not recommend enforcement action under Section 18(f) of the Investment Company Act if the Portfolios use the same qualifying assets to cover both components of those straddles which consist of a combination of a put option and a call option on the same underlying security or on a futures contract on the same underlying asset where the exercise prices of the call and the put are the same or the exercise price of the call is above that of the put, as described above.

If you have any questions, please feel free to call the undersigned at (212) 891-9360 or Joel H. Goldberg at (212) 891-9359.

Very truly yours,

Gregory K. Todd

Gregory K. Todd

25 JUN 1990

Our Ref. No. 90-330-CC
Sanford C. Bernstein
Fund, Inc.
File No. 811-5555

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Your letter of June 13, 1990, requests our assurance that we would not recommend enforcement action to the Commission under Section 18(f) of the Investment Company Act of 1940 ("1940 Act") if Sanford C. Bernstein Fund, Inc., a registered open-end management investment company comprised of series of shares, each of which represents an interest in a separate portfolio of securities (each, a "Portfolio"), engages in certain trading strategies involving straddles on securities and on financial futures contracts as described in your letter. 1/

You state that a Portfolio currently may write straddles that consist of a combination of a put option and a call option on the same underlying security or on a futures contract on the same underlying instrument, so long as the Portfolio provides cover for or segregates liquid assets (cash, U.S. government securities, or other liquid high-grade debt obligations) ("qualifying assets") for each component of the straddle separately in accordance with previous staff positions. 2/

1/ Section 18(f)(1) of the 1940 Act provides, in part, that it shall be unlawful for any registered open-end investment company to issue any class of senior security or to sell any senior security of which it is the issuer, except that the open-end 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 cent for all borrowings of the open-end investment company as computed under Section 18(h) of the 1940 Act. The Commission has stated that certain trading practices that fall within the functional meaning of the term "evidence of indebtedness" may involve leveraging and the issuance by an investment company of a senior security subject to the prohibitions and asset coverage requirements of Section 18. Investment Company Act Rel. No. 10666 (April 18, 1979) ("Release 10666").

2/ See, e.g., Dreyfus Strategic Investing (pub. avail. June 22, 1987); Putnam Option Income Trust II (pub. avail. Sept. 23, 1985) ("Putnam"); Release 10666.

See also Investment Company Act Rel. No. 7221 (June 9, 1972)("Release 7221")(guidelines for the preparation of
(continued...)

As an alternative to providing cover or segregating assets in the manner described above, you now propose that a Portfolio segregate qualifying assets for both components of those straddles where the exercise dates of the put and the call are the same 3/ and where the exercise price of the written call is the same or higher than the exercise price of the written put ("qualifying straddles") in the following manner. In such cases, a Portfolio would segregate with its custodian (not with a futures commission merchant ("FCM") or broker) qualifying assets equivalent to the market price (less, with respect to such qualifying straddles, any initial margin in another segregated account with its custodian in the name of the FCM or broker and less any variation margin temporarily on deposit with the FCM or

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2/(...continued)
Form N-8B-1). In Release 7221, the staff took the view that an investment company desiring to write a call option should provide that (1) it will own and hold for the term of the option, the security against which the call option is written, or (2) it will purchase a call on the same security at the same exercise price, or (3) it will establish at the time of selling the option and maintain for the term of the option, a segregated account consisting of cash, U.S. government securities or other high-grade debt securities, equal to the fluctuating market value of the optioned securities as marked to market daily. The staff also stated that the sale of put options could be offset at the time of sale by (1) the purchase of a put on the same securities at the same price, or (2) a segregated account consisting of cash, U.S. government securities or high-grade debt securities equal to the option price, or (3) a corresponding short sale.

3/ In a telephone conversation with Hope Lewis of the staff on June 21, 1990, Joel Goldberg of your firm confirmed our understanding that the options comprising a qualifying straddle would be options that may be exercised at any time from the day on which they are purchased until the last trading day prior to expiration (i.e., "American-style options"). See Hutton Options Trading L.P. (pub. avail. Feb. 2, 1989) for a discussion of certain transactions involving both American-style options and European-style options (which can be exercised only during a specified period, often limited to the last trading day prior to expiration).

broker) 4/ of the security or instrument underlying a qualifying straddle (as marked to market daily) and the amount, if any, by which the put is "in-the-money" (as marked to market daily). 5/ In addition, when a Portfolio segregates qualifying assets that are the same as the security or instrument underlying a qualifying straddle 6/ (i.e., where the underlying security is itself a liquid high-grade debt obligation), the Portfolio will at all times have asset coverage 7/ of at least 300% for the combined value of those qualifying assets and any senior

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4/ You state that initial margin, variation margin, and any daily settlement due as mark-to-market payments on a Portfolio's short options on futures contracts will be maintained in accordance with previous staff positions. In Putnam, for example, the staff stated that it would not recommend any enforcement action to the Commission under Section 17(f) of the 1940 Act if the initial margin for a futures contract is maintained by a fund's custodian in an account in the name of the fund's FCM, provided that the FCM is permitted access to the account only upon the fund's default on the contract. The staff also stated that it would not recommend any enforcement action to the Commission if a fund's FCM temporarily retains excess variation margin gains overnight or over a weekend. Similarly, in Goldman, Sachs & Co. (pub. avail. May 2, 1986), the staff stated that it would not recommend any enforcement action to the Commission if, under the circumstances described in that letter, a fund pays the daily settlement due as mark-to-market payments on its short options on futures contracts directly to a FCM, rather than maintaining the amounts of such payments at a custodian bank pursuant to a third-party custodial agreement.

5/ A put option is "in-the-money" if the market price of the underlying security or instrument is below the exercise price of the put.

6/ In a telephone conversation with Hope Lewis on June 15, 1990, Gregory Todd of your firm confirmed that the representation in the sentence accompanying this note is applicable to both qualifying straddles on securities and qualifying straddles on options on futures.

7/ Section 18(h) of the 1940 Act defines "asset coverage" of a class of senior security representing an indebtedness of an issuer to mean the ratio which the value of the total assets of the issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of the issuer.

securities (i.e., bank borrowings) the Portfolio has issued. You represent that the components of a qualifying straddle are linked in such a way that the segregation of qualifying assets equal to the market value of the underlying security or instrument plus the amount the put is in the money would be sufficient to meet a Portfolio's obligations under each component of a qualifying straddle, regardless of the order in which the components are exercised, even if the components are exercised simultaneously.

As noted above, in a qualifying straddle the exercise price of the call will be the same or higher than that of the put. With respect to settlement of a qualifying straddle by physical delivery of the underlying security or instrument, you represent that the price received upon settlement if the call is exercised and assigned first is at least as great as the price that would be required to be paid upon settlement if the put is exercised and assigned. Similarly, you represent that, since both options will be written on the same security or instrument, the proceeds received upon settlement if the put is exercised and assigned first are the same as the proceeds that would be required to be delivered upon settlement if the call is exercised and assigned. You represent further that if both components of a qualifying straddle were exercised and assigned on the same day, the settlement of one component of the straddle would provide proceeds sufficient to satisfy a Portfolio's obligations under the remaining component. 8/

In any event, you represent that whenever either component of a qualifying straddle is exercised, a Portfolio would: (1) segregate the proceeds received from the settlement of the call (i.e., cash) or segregate the security or instrument received from the settlement of the put to provide assets sufficient to satisfy its obligations under the remaining component (where exercise of the option results in settlement by physical delivery of the underlying security or instrument); (2) otherwise provide cover for or segregate qualifying assets for the remaining component in accordance with previous staff positions; 9/ or (3) close out the remaining component. The Portfolio will continue to mark to market qualifying assets after it receives notice of the exercise of, or assignment of an exercise notice with regard to, one component of the straddle, until the settlement date for

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8/ If the option is settled in cash only, rather than by physical delivery of the underlying security or instrument, the writer of the option would pay the difference between the exercise price of the option and the market price of the underlying security or instrument.

9/ *See* note 2 and accompanying text.

that component. 10/ You represent that, upon settlement of either component of a qualifying straddle, the Portfolio will have provided cover or have segregated qualifying assets for the remaining component by the end of the same day.

In Release 10666 the Commission stated that the proper use of segregated accounts will limit an investment company's risk of loss and 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. 11/

Notwithstanding these safeguards, the Commission observed 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. 12/

The Commission therefore cautioned directors to consider the potential loss of flexibility when determining the extent to which an investment company should engage in leveraged transactions. 13/ Likewise, the board of directors of each Portfolio should consider the potential loss of flexibility when determining the extent to which a Portfolio should engage in the writing of straddles.

The segregation of qualifying assets equal to a Portfolio's obligations with respect to only one component of a qualifying straddle in the manner you have described appears to provide assets sufficient to meet the obligations of the Portfolio that might arise from a qualifying straddle. However, this manner of providing for the Portfolio's potential obligations (instead of

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10/ With respect to options on futures contracts, under current procedures the Portfolio generally would be required to settle on the same day that it receives notification of the exercise and assignment.

11/ Release 10666.

12/ Id.

13/ Id.

segregating qualifying assets for or providing cover for each component) also would appear to increase the number of qualifying straddles that a Portfolio could write. We note, therefore, that each Portfolio's overall limitations on its use of options would act as a secondary, but important, limit on the total amount of leverage that the Portfolio could undertake. In this regard, you state that no Portfolio will write any option if, immediately thereafter, the aggregate value of the Portfolio's securities or assets subject to outstanding options would exceed 25% of its net assets. Further, you state that no Portfolio will purchase or sell futures contracts or related options if, as a result, the sum of the initial margin deposits on the Portfolio's existing futures positions and premiums paid for options on futures contracts exceeds 5% of the Portfolio's total assets, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; provided, however, that in the case of an option that is in-the-money at the time of the purchase, the in-the-money portion of the premium is excluded in calculating the 5% limitation.

In addition, we take this opportunity to clarify that, in our view, an investment company that writes a put on an underlying security or instrument would not adequately reduce the potential leveraging effect on its assets if it places the same underlying security or instrument in a segregated account, even if that security or instrument is a liquid high-grade asset. With respect to a put that it writes, the investment company's potential obligation (i.e., the exercise price of the put) is fixed. When it writes a put, the investment company takes the risk that the put may be exercised and that it would be required to purchase the security or instrument underlying the put at the exercise price after the underlying security or instrument has declined in value. The use of a segregated account does not eliminate this risk, but limits the amount of puts an investment company may write and ensures that adequate funds will be available to meet potential obligations. If an investment company places qualifying assets in a segregated account that are different from those on which the put is written, there is no direct correlation between the qualifying assets in the segregated account and the security or instrument underlying the put. Therefore, the investment company would not necessarily need to place additional qualifying assets in the segregated account if the underlying security or instrument declines in value. If, however, the investment company segregates qualifying assets that are the same as the security or instrument underlying the put, and the security or instrument underlying the put declines in value, the qualifying assets in the segregated account also would decline in value and the investment company would be required to place additional qualifying assets in the segregated account to meet any potential obligation under the put. 14/

Accordingly, we take the view that a segregated account would eliminate the potential senior security problems arising from the writing of a put by an investment company only if that segregated account consists entirely of liquid assets other than the security or instrument on which the put has been written. In this regard, you have represented that, in addition to maintaining a segregated account as described in your letter, a Portfolio that segregates qualifying assets that are the same as the security or instrument underlying a qualifying straddle also will at all times maintain 300% asset coverage for the combined value of those qualifying assets and any senior securities (i.e., bank borrowings) the Portfolio has issued.

We would not recommend that the Commission take any enforcement action under Section 18(f) of the 1940 Act if each Portfolio that writes a qualifying straddle segregates qualifying assets in the manner described in your letter, provided that when a Portfolio segregates qualifying assets that are the same as the security or instrument underlying a qualifying straddle, the Portfolio also will at all times maintain 300% asset coverage for the combined value of those qualifying assets that are the same as the underlying security or instrument and any senior securities (i.e., bank borrowings) the Portfolio has issued as described in your letter. Because this position is based on the facts and representations in your letter, you should note that any different facts or representations may require a different conclusion. Further, this response only expresses the Division's position on enforcement action and does not purport to express any legal conclusion on the issues presented.

L. Hope Lewis

L. Hope Lewis
Attorney

14/ By contrast, an investment company that writes a call on the same security or instrument that it owns risks being unable to participate in any potential gain from an increase in the value of the underlying security or instrument. The staff takes the view that the risk associated with the writing of a covered call does not raise a senior security issue. See, e.g., Release 7221.