Investment Company Act
§§ 17(f) and 18(f)

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November 18, 1983

Act ICA-40
Section 18(f)
Rule
Public
Availability 1/17/84

Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Attn: Mr. Sidney L. Cimmet
Chief Counsel
Division of Investment Management

Dear Sirs:

SteinRoe Bond Fund, Inc.
File No. 811-2878
Request for No-action Letter

We are writing on behalf of SteinRoe Bond Fund, Inc. (the Fund), a registered open-end management investment company, to request a no-action letter in connection with proposed changes in the investment policy and investment restrictions of the Fund that would permit the Fund to enter into interest rate futures contracts. The proposed changes have been recommended by the Fund's board of directors and are to be submitted for approval or disapproval by the shareholders at their 1983 annual meeting scheduled to be held in December 1983.

For your information we are enclosing a copy of the Fund's prospectus dated November 1, 1983 and a copy of a proposed supplement to the prospectus to be dated December 16, 1983 showing the changes proposed to be made in the prospectus to reflect the possible use of futures contracts for hedging purposes (see in particular Appendix D on pages 26-31 of the prospectus, especially proposed restriction 11 on page 31).

Section 18(f)

Section 18(f) of the Investment Company Act of 1940 (the Act) contains a broad prohibition against the issuance of a senior security by an open-end investment company. Because a party to an interest rate futures contract is required to pay money or deliver a security at a future date to fulfill its obligations under the contract, it might be argued that an investment company that enters into a futures contract has issued a senior security, on the ground that the contract, which would have priority over stockholders in the distribution of assets of the investment company, might be construed to evidence an indebtedness. However, the staff of the Commission has acquiesced in an investment company's use of futures contracts if certain limitations are observed in order to assure that the futures contracts would not increase unduly the speculative character of the common stock of the fund. See no-action letters concerning IDS Bond Fund, Inc. (available April 11, 1983) and Montgomery Street Income Securities, Inc. (available April 11, 1983), item 4(f) of Guidelines to the Preparation of Form N-8B-1 (Investment Company Act release no. 7221, June 9, 1972), and Investment Company Act release no. 10666, April 8, 1979.

The Fund proposes to use interest rate futures contracts only for hedging purposes and not for speculation. The Fund will hedge against anticipated interest rate changes by selling a futures contract against longer term bonds held in its portfolio or by buying a futures contract against its shorter term investments as an alternative to switching to longer term investments. The purposes, procedures and risks of such use of futures contracts are described more fully in Appendix D to the enclosed prospectus.

As noted in proposed investment restriction no. 11 on page 8 of the prospectus, the Fund will not enter into a futures contract if, as a result thereof at the time of entering into the contract, (i) the aggregate futures market prices of financial instruments required to be delivered under open futures contract sales plus the aggregate purchase prices under open futures contract purchases would exceed 30% of the value of the Fund's total assets or (ii) more than 5% of the value of the Fund's total assets would be committed to margin.

The Fund will make daily settlement of variation margin payments, and in computing daily net asset value will mark its open contracts to market. Furthermore, in the case of an interest rate futures contract purchase, in order to be certain that the Fund has sufficient assets to satisfy its obligations under a futures contract, the Fund will earmark to the futures contract money market instruments in its portfolio equal in value to the current value of the underlying instrument less the margin on deposit. To the extent that the Fund earmarks a money market instrument to a futures contract, that instrument will not be earmarked to, or used to support, any other transaction.

In our opinion, because the Fund will be utilizing futures contracts only for hedging purposes and only within the limits described above, the Fund's use of futures contracts will not "increase unduly the speculative character" of the common stock of the Fund within the meaning of section 1(b)(7) of the Act as that phrase has previously been interpreted by the staff. Therefore, its use of futures contracts should not be objectionable to the staff by reason of section 18(f).

<u>Section 17(f)</u>

Any futures commission merchant (FCM) through whom the Fund would enter into a futures contract would establish with the Fund's regular custodian bank a separate custodial account in the name of the FCM to hold the Fund's initial margin deposits that are required in connection with its futures contracts entered into through that FCM. The FCM would agree that (i) the assets in the account will at all times be maintained with the custodian unless released back to the Fund or sold or disposed of as permitted under the Fund's agreement with the FCM and (ii) in directing any disposition of the assets in the account, the FCM must state that all conditions precedent to its right to direct disposition have been satisfied. Since the assets in the account would be required to be held by the Fund's custodian until disposed of in accordance with the Fund's agreement with the FCM, the Fund would be in compliance with section 17(f) with respect to those assets.

With respect to variation margin required for "marking to market" in connection with the Fund's futures contracts, the Fund will have an agreement with each FCM through whom

it enters into a futures contract requiring the Fund to pay to the FCM, or the FCM to pay to the Fund, an amount equal to any change in the value of the futures contract on a daily basis. The Fund would be entitled to a payment from the FCM to the extent of any unrealized gain in the value of the contract above the amount of the net (initial and variation) margin the Fund has already deposited. Conversely, the Fund would be required to pay to the FCM any excess of the value of the contract over the net margin deposited by the Fund.

The FCM would notify the Fund, after the close of trading each businss day, of the amount of margin owed to or payable by the Fund by 10:30 a.m. Chicago time on the next business day. Thus, in the case of an amount payable by the FCM to the Fund, the FCM would be in the position of holding an asset of the Fund overnight or over a weekend, theoretically putting the Fund in the position of having assets outside the control of its custodian. However, the Fund would demand to receive payment from the FCM of any excess margin by 10:30 a.m. on such next business day, and all payments by the FCM to the Fund would be paid to the Fund's custodian.

The staff of the Commission has previously indicated to other funds that an FCM's holding of excess margin deposits overnight or over a weekend would be considered to be incidental to the futures transaction and of insufficient duration to violate section 17(f), provided that the fund demands payment promptly upon notification by the FCM of the Fund's right to receive payment. See no-action letters concerning IDS Bond Fund, Inc. (supra) and Montgomery Street Income Securities, Inc. (supra).

* * * *

We request that the staff confirm that it will not recommend enforcement action to the Commission under section 17(f) or 18(f) of the Act based on the Fund's use of interest rate futures contracts as described in this letter and in the enclosures.

Should you desire additional information regarding this matter, please telephone the undersigned or R. James Gormley of our firm.

Please acknowledge receipt by stamping and returning a copy of this letter in the enclosed envelope. Two additional copies of this letter are enclosed in accordance with Investment Company Act release 6330.

Very truly yours,

BELL, BOYD & LLOYD

By
Cameron S. Avery

CSA:jm

Copy to Mr. James D. Winship
Executive Vice President
SteinRoe Bond Fund, Inc.

PUBLIC

JAN 17 1984

RESPONSE OF THE OFFICE OF CHIEF COUNSEL
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 83-442-CC
SteinRoe Bond Fund, Inc.
File No. 811-2878

SteinRoe Bond Fund, Inc. (the "Fund") is a registered open-end management investment company. The Fund proposes to enter into interest rate futures contracts as a hedge against the effects of fluctuating interest rates. In this regard, the Fund will hedge by selling interest rate futures contracts against longer term bonds held in its portfolio ("short hedge") or by purchasing interest rate futures contracts against shorter term investments instead of switching to longer term investments ("long hedge").

You raise two issues with respect to the above transactions in your November 18, 1983 letter. The first issue is whether the Fund's sale or purchase of interest rate futures contracts would constitute the issuance of a senior security in violation of section 18(f) of the Investment Company Act of 1940 ("Act"). The second issue relates to the custody of margin payments required to be made to the Futures Commission Merchant ("FCM") in connection with interest rate futures contracts and whether this custody arrangement would violate section 17(f) of the Act. These two issues are discussed below.

With the exception for borrowing from a bank, section 18(f) of the Act prohibits an open-end investment company from issuing any class of senior security. Section 18(f) of the Act defines senior security to include, among other things, an obligation evidencing indebtedness.

Interest rate futures contracts are settled in cash, by delivery of the underlying securities, or by the taking of an opposite or offsetting position. 1/ The seller's obligation evidences an indebtedness to settle in cash

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1/ Settlement in cash is accomplished by the buyer or seller paying or receiving cash equal to the difference in market value between the futures settlement price on the next to last trading day of the settlement month and the value of the actual underlying financial instrument at the close of the last trading day. Up until this point, the contract is settled daily through the mark-to-the-market system.

Some interest rate futures contracts may be settled by delivery of the underlying security. In that case, the seller is obligated to deliver the instrument underlying the contract. The purchaser is obligated to make a cash payment equal to the contract strike price upon delivery and to accept the instrument.

Most interest rate futures contracts are settled by the taking of offsetting positions, e.g., a seller of a contract offsets by purchasing a contract and a purchaser of a contract offsets by selling a contract. The offsetting contracts are for the same underlying instrument and for the same delivery month. In the case of a seller offsetting the contract

[Footnote continued on next page]

or in kind. The purchaser's obligation evidences an indebtedness to settle in cash. Because the definition of senior security includes an evidence of indebtedness, the Fund's participation in the interest rate futures market as a seller or a purchaser raises issues with respect to the prohibition contained in section 18 of the Act.

Section 18 was designed to mitigate the effects that excessive borrowing or issuance of other senior securities have on the experiences of senior and junior security holders. With respect to the senior security holders, section 18 was created to eliminate conditions which would result in an investment company's, because of leveraging and excess speculation with borrowed money, being unable to adequately cover its borrowings with sufficient assets to repay the senior security holders promptly. See H.R. Rep. No. 2639, 76th Cong., 3d Sess. (1940); SEC, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, H.R. Doc. No. 279, 76th Cong., 1st Sess., Part III, 1672 (1939). Insofar as the junior security holders are concerned, section 18 was intended to reduce speculative transactions which over expose the junior security holders to losses. See Investment Company Act of 1940, §1(b)(7); SEC, Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies, supra, at 1708.

The following example, in which an investment company has $2 million in assets and borrows $1 million, is illustrative of the effects of leverage on junior security holders. The value of the company's total assets that can be invested equals $3 million. If the value of the invested $3 million drops 10%, i.e., to $2.7 million, and the investment company is obligated to repay the $1 million loan, the interest of the junior security holders would be reduced to $1.7 million. If the company had not borrowed and had only invested the $2 million of assets, a 10% drop in value would have resulted in its having $1.8 million in assets. Thus, the borrowing would have the effect of increasing the loss of the junior security holders from $200,000 to $300,000, i.e., by 50%.

While the entry into a futures contract may be considered a highly leveraged transaction because a "margin" payment, equal to a small percentage of the market value of the contract, enables the holder of such contract to experience the change in the market value of the contract, the Fund's sale and purchase of these contracts will be for hedging purposes

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[Footnote continued from previous page]

by purchasing a contract, a gain is realized if the purchased contract price is less than the price of the contract originally sold. A loss is taken if the purchased contract price is more than the price of the contract sold. A purchaser offsets by selling an interest rate futures contract and realizes a gain if the price of the contract sold is more than the price of the contract originally purchased. The purchaser realizes a loss if the price of the contract sold is less than the price of the purchased contract.

only. A hedging transaction is intended to reduce risk of loss, not increase it. 2/ Therefore, the use of these contracts as a hedge would not offend the protective purposes behind section 18 to eliminate or mitigate the issuance of senior securities which increase unduly the speculative character of junior securities. Insofar as the protection of the persons on the other side of a futures contract entered into by the Fund is concerned, which persons may be analogized to the holders of senior securites, the futures clearing house as well as the Commodity Futures Trading Commission have rules regulating the entry into futures contracts and the futures clearing house is responsible for the performance of the contracts.

Although the Fund's intent is to hedge, that is, to reduce its risk of loss, it is possible such intent is not realized because of the product of differences between (1) the movement of the Fund's portfolio and the movement of the value of the financial instrument underlying the futures contracts the Fund enters into as a hedge and (2) the movement in the value of such instrument and the movement of the price of futures contract on that instrument. Where the futures transactions are limited to hedging purposes, however, the risks present in such transactions, i.e., the risks of misforecasting the movement of the Fund's portfolio in comparison to the movement of the value of the underlying financial instrument and the movement of that instrument in comparison to the price of the futures contract on that instrument, do not involve a risk of leverage, such as that illustrated above, and, thus, are not the types of risk section 18 was intended to limit.

2/ In order to protect against a decline in the value of its portfolio resulting, for example, from an increase in interest rates, the Fund would enter into a short hedge by selling an interest rate futures contract, instead of liquidating or adjusting its portfolio securities and incurring the incident transaction charges. To the extent that an increase in interest rates results in a decrease in futures prices and produces gains in the Fund's futures position that offset the decline in the value of the Fund's portfolio, the futures position would reduce the Fund's loss. Further, if interest rates go down, the Fund would be unharmed to the extent that losses in its futures position would be offset by increases in the value of its portfolio securities.
When the Fund wishes to remain in short-term instruments because the return on such instruments is higher than the return on long-term instruments, and at the same time to avoid the risk that declining interest rates would result in its having to pay higher prices for the long-term bonds it intends to acquire in the future, the Fund would enter into a long hedge by purchasing an interest rate futures contract. To the extent that a decrease in interest rates would result in gains on the Fund's futures position which offset the higher prices to be paid by the Fund for long-term instruments, the Fund would be protected against such increases in prices. Further, if interest rates go up, the Fund would be unharmed to the extent that its losses on its futures position are offset by any difference between what it pays for the long-term bond and the larger price it would have paid for the bond if it had purchased the bond instead of entering into the futures transaction.

The Fund indicates that it would not enter into a futures contract if the aggregate market price of all of the Fund's open futures positions would exceed 30 percent of the Fund's total assets or if more than 5 percent of the Fund's total assets would be committed to margin on such futures contracts. The Fund will sell interest rate futures contracts as a hedge against changes in the value of its portfolio securities. It will do so within limits, such as those proposed, which are consistent with that purpose. In these circumstances, for the reasons set forth above, we would not recommend enforcement action to the Commission for violation of section 18(f) if the Fund enters into such transactions. Cf. Investment Company Act Release 7221 (pub. avail. June 9, 1972) with respect to the treatment of short sales against the box.

The Fund intends to purchase interest rate futures contracts as a hedge against a decline in interest rates which would result in higher bond prices. The Fund would enter into the long hedge when (1) short-term rates are higher than long-term rates, and (2) it intends to buy long-term bonds at a future date and at anticipated higher prices. In addition to the limitations expressed above with respect to the short hedge, the Fund represents in its November 18, 1983 letter, that it would earmark with its custodian money market instruments equal to the fluctuating market value of the long futures contracts it has purchased, less any margin deposited on the long positions. These earmarked assets would not be used to support any other transaction in which the Fund may enter. The Fund will purchase interest rate futures contracts as a hedge within the limitations and under the conditions expressed. In these circumstances, for the reasons set forth above, we would not recommend enforcement action to the Commission for violations of section 18(f) if the Fund enters into such transactions. Cf. Investment Company Act Release 10666 (pub. avail. April 18, 1979) with respect to firm commitment agreements.

You present two questions with respect to the applicability of section 17(f) of the Act. The first relates to the manner in which the margin account is held. The second relates to the manner in which an FCM is required to make payments to the Fund.

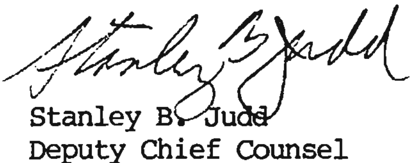
You state that the Fund would establish a custodial account with its bank custodian to hold initial margin payments. Under such an arrangement, the account would be in the name of the FCM, who could gain access to the assets held in the account only if he states that all conditions precedent to his right to direct disposition have been satisfied.

Daily gains and losses resulting from changes in the value of the futures positions would be debited or credited to the Fund's custodial account. The payments to or withdrawals from this account are known as variation margin payments. The Fund could withdraw amounts in excess of the initial margin. In addition, if the margin account is depleted below the maintenance level (a fixed percentage of the initial margin, e.g., 70%), the Fund would be required to deposit an amount that would bring the margin account balance back up to its initial margin level.

If the Fund has an unrealized gain above the amount of any net variation margin it has already received, the FCM, as of the close of that trading day, may receive, on behalf of the Fund, a variation margin payment from the clearing corporation in the amount of such gain. By 10:30 a.m. the next business day, the FCM would notify the Fund of its entitlement to receive a variation margin payment whereupon the Fund is able to demand this amount from the FCM. You state that any agreement which might be entered into between the Fund and the FCM will require the FCM to pay to the Fund or receive from the Fund an amount equal to any change in value of the futures contract on a daily basis. It is the Fund's intention to receive or pay out the monies on such basis. It is also the Fund's intention, as you represented in a telephone conversation with Stephanie Monaco of the staff on January 11, 1984, that at any time that the balance in the bank custodial account exceeds the required margin, the Fund will withdraw that excess promptly.

Based on these representations, we would not recommend any action under section 17(f) because the margin account at the Fund's bank custodian is in the name of the FCM. See, Claremont Capital Corp. (pub. avail. September 16, 1979). In addition, although the FCM may hold any excess margin overnight or over a weekend for the Fund's account, we would consider such custody by the FCM to be incidental to the transaction and not of sufficient duration to trigger the requirements of section 17(f) and the rules thereunder if the Fund demands payment promptly upon notification by the FCM that funds are due. Therefore, based on the facts and on the representations contained in your letter, we would not recommend enforcement action to the Commission under section 17(f) of the Act if the Fund pays and receives variation margin in the manner you have described.

This response, as a result of your consent, will be made public upon issuance.



Stanley B. Judd
Deputy Chief Counsel