

**MEMO# 5930**

May 31, 1994

# **INSTITUTE LETTER TO N.Y. ATTORNEY GENERAL CONCERNING MUTUAL FUNDS AND LEVERAGE**

May 31, 1994 TO: SEC RULES COMMITTEE NO. 57-94 RE: INSTITUTE LETTER TO N.Y.  
ATTORNEY GENERAL CONCERNING MUTUAL FUNDS AND LEVERAGE

The Institute recently sent a letter to G. Oliver Koppell, the Attorney General of the State of New York, to clarify an issue concerning mutual funds and leverage. The issue arose in the context of a letter from Mr. Koppell to SEC Chairman Arthur Levitt concerning the N.Y. Attorney General's investigation of and settlement with a municipal bond mutual fund that invested a substantial portion of its assets in inverse floaters. (See Memorandum to SEC Rules Members No. 31-94, dated May 2, 1994.) Copies of both letters are attached. In his letter to Chairman Levitt, Mr. Koppell suggested that fund purchases of "leveraged" inverse floaters may violate the limits under the Investment Company Act on leveraging by investment companies. The Institute's letter explains that inverse floaters do not raise the same leveraging concern that Section 18 of the Act is intended to address, i.e., the risk of losses in excess of a fund's capital. Rather, the maximum amount that a fund that purchases inverse floaters has at risk is the amount it invested in such instruments. The Institute's letter notes that the "leverage characteristics" of inverse floaters refer to their relative sensitivity to changes in interest rates and resulting potential volatility. The letter suggests that the impact of such investments should be taken into account in connection with disclosures to investors concerning a fund's overall interest rate risk. Insofar as funds can increase or decrease their exposure to interest rate risk in a variety of ways (through derivatives or otherwise), however, the Institute's letter expresses the view that it would be inappropriate to single out a particular type of instrument, such as inverse floaters, for limitations that would not apply to the fund's other investments. Frances M. Stadler Associate Counsel Attachments