



## Delta Government Options Corp.

127 John Street New York, N.Y. 10038

(212) 742-0270

Act	ICA-40	Investment Company Act of
Section		1940, Section 17 and Rule
Rule	17f-4	17f-4 thereunder
Public		
Availability	9/27/90	August 27, 1990

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

RE: Delta Government Options Corp.; Supplementary  
No-Action Request to your Reference No. 89-66-CC  
(File No. 132-3)

Dear Mr. Harman:

Counsel to Delta Government Options Corp. ("Delta"), requested by letter dated February 1, 1989 that the staff of the Division of Investment Management take four no-action positions with respect to participation by registered investment companies in Delta's over-the-counter options trading system (the "No-Action Request"). In a letter dated July 21, 1989 (your Reference No. 89-66-CC; File No. 132-3) you declined to take a no-action position on three of the four issues presented, and took a no-action position on a portion of the fourth issue (the "No-Action Reply").

In a subsequent telephone discussion between you, and certain members of your staff, and our counsel, you suggested that additional information might be relevant to further consideration of two of the three issues on which you declined to take a no-action position.

Accordingly, Delta hereby requests that you consider the following as a supplementary submission with respect to the No-Action Request. The defined terms used in this letter have the same meaning as set forth in the No-Action Request.

Thomas S. Harman. Esquire  
August 27, 1990  
Page 2

### Delta as a Securities Depository

The No-Action Request requested that Delta be treated as a securities depository for purposes of Rule 17f-4 under the Act. The No-Action Reply declined to grant such relief on the basis that it was not apparent that options within the System can be pledged, as required by Rule 17f-4.

Further to the telephone discussion on the subject, Delta represents to you that options within the System may be pledged, subject to satisfaction of requirements consistent with the integrity of the System, although for the practical reasons discussed below, Delta expects that such pledges will be relatively infrequent. Delta also believes that registered investment companies would have no conceivable reason to pledge open option positions.

The operating procedures governing the System are set forth in the "Procedures of the Over-the-Counter Options Trading System" (the "Procedures"), which have been approved by the Commission under Section 19(b) of the 1934 Act, and which may not be amended without such approval. The basis upon which a Participant may enter into option transactions on the System and the Participant's rights with respect to transferability of options on the System, are set forth in Section 211 of the Procedures, which provides:

Each participant shall effect Option Contracts as principal for its own account, and not on behalf of customers or other persons. No Option Contract issued by the Issuer [i.e. Delta] shall be transferred or pledged by a Participant, except in accordance with the Procedures or with the prior written consent of the Issuer; the Issuer shall have no obligation to register any purported transfer or pledge in violation of this Section 211; and any such purported transfer or pledge shall be ineffective as against the Issuer."  
(emphasis added)

It is plain that the Procedures do not prohibit pledges, and that pledges are contemplated, but are subject to appropriate controls if the pledge is to be recorded in the System in favor of the pledgee, which would give the pledgee rights as a Participant in the System. A pledge can occur even without such record right being created. At present, there are no specific provisions in the Procedures to govern pledges, since such pledges would be likely only under somewhat unusual and specialized circumstances, in which

Thomas S. Harman. Esquire  
August 27, 1990  
Page 3

both the pledgor and pledgee would be sophisticated institutional parties with specific needs and objectives relative to the pledge which would have to be reconciled with the needs and objectives of the System. Delta will develop pledge procedures in which the pledge will be recognized by the System to be consistent with such needs and objectives once they have been identified by a participant. For example, Delta understands that one Participant which is a government securities dealer may want to develop pledge procedures to support its bank borrowings to finance long hedge positions. The procedures for such a pledge would best be worked out in the context of an actual proposed transaction, rather than as an abstract proposition.

Delta believes that under the Procedures as currently stated it could approve certain types of pledge arrangements which have no impact on and do not need to be recognized as a matter of record on the System. For example, in the case noted above, if the dealer granted a lender bank the right in the event of default to require the dealer to exercise or close a profitable long option position and remit proceeds to the bank, net of other obligations to the System, Delta believes that it could properly recognize such instructions at the time of the transaction under the System. The bank's interest would not necessarily be "perfected" however and might be challenged by a third party creditor of the dealer. To differentiate, however, if the dealer wished to grant an ongoing perfected record security interest in all of its positions on the System to the bank, a number of controls and procedures might have to be developed to protect the System while serving the commercial needs of the dealer and bank, and in such case an amendment to the Procedures under Section 19(b) of the 1934 Act would be warranted.

The Staff should take into account that the value of derivative instruments such as options are seldom realized by transfer or pledge. Options have a limited life and are subject to significant price volatility during that life, with price being driven both by intrinsic values based upon the exercise price and the price of the underlying security, and by the time remaining until expiration of the option. Favorable price movements are realized by executing closing transactions, or in the case of long option positions, the holder may alternatively exercise the option. Short option positions appear to have no asset that could be pledged, since the holder has a premium and the obligation to deliver the underlying security.

The central point to be made for purposes of Section 17(f) of the Act, however, is that investment companies can pledge their options under the System, subject to appropriate System safeguards if the pledgee's interest is to appear of record on the

Thomas S. Harman. Esquire  
August 27, 1990  
Page 4

System, but it is extremely unlikely, if not inconceivable, that they would have occasion to do so. As experience with other option clearing corporations indicates, the typical and most economically efficient way for an investment company to realize value on an option position is a closing transaction or exercise. An investment company would pledge assets only against permitted borrowings, which typically would only be for temporary or emergency purposes, or in some cases for investment leverage. In either case, the stable source of the collateral in form suitable for pledging by an investment company lies in its portfolio securities. Investment companies do not engage in dealer trading financing, and would have no occasion to pledge an option position.

#### Deposit of Margin and Cover

A Participant in Delta's System that is a registered investment company will be permitted to deposit margin or cover for options it writes with Delta by causing the same to be transferred to an account at such investment company's custodian in an account in the name of Delta or Delta's clearing bank, provided that Delta or Delta's clearing bank will be permitted to withdraw the deposited margin or cover only upon the investment company's default on the option contract. The investment company would be expected to receive excess margin or return of cover daily, but occasionally may not receive the same until the next business day.

Staff of the Division of Investment Management have in the past stated it would not recommend any enforcement action to the Commission under Section 17(f) if (i) margin or cover were deposited in the manner specified in the preceding paragraph or (ii) excess margin or cover were temporarily retained overnight or over weekends in such account. Putnam Option Income Trust II (pub. avail. Sept. 23, 1985) and supporting letters cited therein.


#### Requested Relief

Based upon the information discussed above, Delta requests your advice that the Division of Investment Management would not recommend enforcement action under Section 17(f) of the Investment Company Act of 1940, as amended, if registered

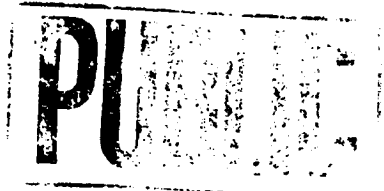
Thomas S. Harman. Esquire  
August 27, 1990  
Page 5

investment companies utilize Delta as a securities depository for purposes of Rule 17f-4 and deposit margin or cover for options contracts as described herein.

Very truly yours,

  
David Maloy  
President

DM:dro  
/SEC-TSH



27 SEP 1990

RESPONSE OF THE OFFICE OF CHIEF COUNSEL  
DIVISION OF INVESTMENT MANAGEMENT

Our Ref. No. 90-451-CC  
Delta Government  
Options Corp.  
File No. 132-3

Your letter of August 27, 1990, requests our assurance that we would not recommend that the Commission take any enforcement action if registered investment companies (1) utilize Delta Government Options Corp. ("Delta") as a securities depository under Rule 17f-4 of the Investment Company Act of 1940 ("1940 Act"), 1/ or (2) deposit margin or cover for options at the investment company's custodian in an account in Delta's name or in the name of Delta's clearing bank without violating Section 17(f) of the 1940 Act.

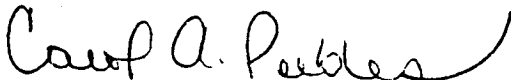
With respect to whether Delta qualifies as a securities depository under Rule 17f-4, we note that Delta issues options in uncertificated form, maintains central book-entry records of all options issued, effects all transfers by book-entry, and treats options of the same type or series as fungible. 2/ You state that under the system's current procedures, Delta believes that it can approve certain types of pledge arrangements that do not need to be recognized as a matter of record on the system. 3/ You further state that Delta will develop pledge procedures that will be recognized by the system, consistent with the needs and objectives of the system and participants.

With respect to the deposit of margin or cover in compliance with Section 17(f), you state that a registered investment company will be permitted to deposit margin or cover for options its writes with Delta by transferring the appropriate amount to the investment company's custodian, held in an account in Delta's name or in the name of its clearing bank, provided that Delta or its clearing bank will be permitted to withdraw the deposited

- 
- 1/ Rule 17f-4 defines a securities depository as a "system for the central handling of securities where all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of securities."
- 2/ See Delta Government Options Corp. (pub. avail. July 21, 1989).
- 3/ In general, the operating procedures governing the system provide that an option contract issued by Delta may be pledged by a participant in accordance with the procedures or with Delta's prior written consent. The Commission approved the operating procedures governing Delta's system under Section 19(b) of the Securities Exchange Act of 1934. The Commission would also have to approve any amendments of the procedures.

margin or cover only upon an investment company's default on an option contract. Further, an investment company would be expected to receive excess margin or return of cover daily, but occasionally not until the next business day. 4/

On the basis of the facts and representations in your letter of August 27, 1990 (and your letter of February 1, 1989), we would not recommend that the Commission take any enforcement action under Section 17(f) of the 1940 Act, or Rule 17f-4 thereunder, if registered investment companies proceed as described in your letter of August 27th. Because this response is made on the basis of your facts and representations, you should note that any different facts or representations might require a different conclusion. Moreover, this response only expresses the Division's position on enforcement action and does not purport to express any legal conclusions on the questions presented.



Carol A. Peebles  
Acting Special Counsel

---

4/ See generally Putnam Option Income Trust II (pub. avail. Sept. 23, 1985) (overnight retention of excess margin by a fund's futures commission merchant does not violate Section 17(f) of the 1940 Act).