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**Panel on Derivative Investments
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PANEL ON DERIVATIVE INSTRUMENTS

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**PANEL ON DERIVATIVE INSTRUMENTS
USES, LEGAL ISSUES, INVESTOR INFORMATION,
COMPLIANCE AND DIRECTOR OVERSIGHT**

I. DERIVATIVE INSTRUMENTS AND THEIR USES

A. Background

1. Although simple derivative instruments such as options have been around for hundreds of years, the modern complex derivatives grew out of the work of Harry Markowitz who in 1952 quantified the relationship between risk and return and applied formulas to portfolios as a whole.
2. The 1970's saw trading of the first financial futures and by the late 1980's, new instruments, generally defined as hybrids and commonly called structured notes, began to appear. These instruments look like one type of security but have the risk-return characteristics of another.

B. Derivative instruments

1. Broad categories
 - a. Forwards -- contracts to purchase or sell a specific currency, commodity or security for a specified price at a date set further in the future than normal settlement and which may require cash payments on the date of the contracts.
 - b. Futures -- contracts to pay cash based on the price of standardized units of commodities including indices of securities such as the Standard & Poor's 500 Stock Index on set future dates that require a deposit at the outset, "initial margin", and daily cash transfers to cover the day's computed losses "variation margin."
 - c. Options -- contracts that give one party the right to buy or sell a specific currency, commodity or security at a specified price over some period of time. The party obtaining the right to buy or sell typically pays a premium for that right. Warrants can be viewed as long-term options.
 - d. Hybrids -- contracts that contain elements of futures and bank deposits or securities. Often these instruments pay a coupon rate like a bond but the amount of principal that is repaid is based on the change in a foreign exchange rate or a securities index.

- e. Swaps -- contracts to exchange the differences between specifically identified cash flows such as the payment of interest rates or investment returns at various future points in time for a stated period of time. A swap usually is settled periodically on a net basis.

2. Regulatory overview

- a. Trading in currencies and in forwards and options on currencies is not regulated in the U.S. or in most countries unless those countries impose restrictions on their currency movements. Trading in futures on currencies is regulated in most countries. In the U.S., it is regulated by the Commodity Futures Trading Commission (CFTC).
- b. Trading in commodity contracts for future deliveries (futures) and options on such futures is regulated in most countries. In the U.S. by the CFTC.
- c. Trading in securities and in forwards and options on securities is regulated in most countries. In the U.S. by the Securities and Exchange Commission (SEC) and by state securities commissions.
- d. Rules 34.1, 34.2 and 34.3 under the Commodity Exchange Act, amended in 58 Fed. Reg. 5580 (January 22, 1993), exempt from regulation by the CFTC hybrids that
 - (1) are otherwise subject to securities or banking laws;
 - (2) have a greater value ascribable to their non-commodity component than to their commodity component as defined in the Rules;
 - (3) require full payment of the purchase price up front;
 - (4) do not call for a delivery of a security or commodity at settlement that is a specified delivery instrument for exchange traded futures; and
 - (5) are not marketed as being or having the characteristics of a futures contract or commodity option.
- e. A recent letter from Acting CFTC Chairman Sheila Bair to SEC Chairman Arthur Levitt (dated September 22, 1993) specifies that certain hybrids linked to equity securities do not qualify under CFTC Rule 34.3, but should instead be analyzed under the Statutory Interpretation Concerning Certain Hybrid Instruments issued by the CFTC on April 11, 1990 (55 Fed. Reg. 13582, CCH Comm. Fut. L. Rep. paragraph 24,805). The Statutory Interpretation exempts hybrids that, among other things:

- (1) are indexed to their underlying instrument on no more than a one-to-one basis (as defined); and
- (2) have a "commodity-independent yield" (as defined) between 50% and 150% of market yields for comparable non-indexed debt securities.

If a hybrid fails to qualify for exemption from CFTC regulation, it may be deemed to be a prohibited contract and not enforceable. The investment company must demand adequate protection from the issuer or dealer against the possibility of an instrument failing to qualify for exemption.

- f. Swaps are viewed by the CFTC as potentially within their jurisdiction. However, the CFTC has determined not to prohibit or regulate their use if certain conditions (summarized below) are satisfied. Most other countries also do not regulate swaps among sophisticated parties. CFTC Rules 35.1 and 35.2, 58 Fed. Reg. 5587 (January 22, 1993), exempt swaps that
 - (1) are between eligible swap participants;
 - (2) are not part of a fungible class of agreements that are standardized as to their material economic terms;
 - (3) are based on the creditworthiness of the parties; and
 - (4) are not traded on multilateral transaction execution facilities.

C. Creation of derivatives

1. Exchange traded derivatives

- a. A derivative is devised by a securities or a commodity exchange based on an index, pools of securities, interest rates, commodities or currencies.
- b. Each derivative has unique contract specifications, such as contract size and minimum price fluctuation.
- c. Each derivative also has specific settlement procedures. For example, it may be self-activating so if it is in the money on settlement date, the gain will be paid without further action. Others, however, require some act to exercise the right to receive the gain, or else it is lost.

2. Privately negotiated (over-the-counter) contracts
 - a. Some derivatives are manufactured by dealers to offer to a number of customers. Generally, these derivatives are narrowly focused and intended to meet investment needs of a group of institutional investors. They include stripped bonds and structured securities.
 - b. Other derivatives are specifically negotiated between buyer and seller either directly or through an intermediary to specifications of the buyers. Generally, these derivatives focus on specific investment needs or risks to be managed and often take the form of forwards, options or swaps.

D. Reasons to use derivatives

1. For an operating company
 - b. Need to fix or reduce volatility of some business variable such as raw material costs, wages, financing costs or currency fluctuations on revenues from goods sold.
 - c. Issue debt securities at lower interest rates.
2. For a dealer (brokers, banks, government agencies, and exchanges that often become counterparties or intermediaries to the derivatives)
 - a. Facilitate the packaging, underwriting or trading of currencies, commodities or securities.
 - b. Reduce the amount of capital needed to engage in business activities by reducing the risk to that capital.
 - c. Earn fee income.
 - d. Charge spreads that may be larger than the spreads on many securities because of the specialized investment options.
3. For an investment company
 - a. Modify risk/return characteristics of the investment portfolio with minimum disturbance to the portfolio.
 - b. Generate returns by selling potential future returns that the manager judges to have more risk than other available returns.

- c. Make market calls when the manager believes the returns on a particular element of the portfolio will change favorably or adversely in comparison to other available returns.
- d. Achieve low transaction fees and reduced friction costs (stamp taxes, withholding) when seeking broad exposure to specific foreign markets.
- e. Execute transactions quickly and without affecting the cash market.
- f. As an alternative to taking a comparable investment position in the cash market or a way of increasing the investment exposure.

E. Examples and uses of derivatives

1. While some derivatives are designed to replicate cash-market security returns on a one-to-one basis, the unique utility of derivatives for an investment company is the ability to decrease market exposure (through hedging) or increase it (through "leveraged" investment positions).
2. Often, several different combinations of derivatives can be used to create essentially the same total return characteristics. Although the resulting investment positions are not identical, their regulatory treatment can differ far more than their returns.
3. Examples of duration-increasing strategies using derivatives. Assume Bond Fund (Fund) with a flexible maturity policy has \$100 invested in XYZ Corp. AA-rated five-year bonds and \$100 in money market instruments. The investment view is that five-year rates will fall significantly over the next three months. The Fund wishes to double its exposure to five-year rates over that period, but wants to keep its cash position as flexible as possible.
 - a. Without using derivatives, the Fund could increase its interest rate exposure by using its cash position to buy another five-year bond, or by selling its XYZ Corp. five-year bonds and buying ten-year or fifteen-year bonds.
 - (1) Buying another five-year bond uses up the Fund's cash position, reducing flexibility.
 - (2) Buying a ten-year or fifteen-year bond would leave the cash position intact, but would increase exposure to long-term rates rather than five-year rates.

- b. Using forward contracts, the Fund could buy a \$100 five-year fixed-rate bond forward, for settlement in three months. (The forward may be settled by actually purchasing the physical bond or by cash settlement.)
- (1) Investment risk equals two times the risk of owning the five-year bond.
 - (2) Cover by segregating \$100 XYZ bond. Cash position remains flexible and could be invested in other securities.
 - (3) Cover must be marked to market daily; cash will be required in three months (and could be supplied from the cash position, by closing out the forward or selling the XYZ bond); counterparty risk if other party to forward fails to deliver.
- c. In the futures market, the Fund could buy \$100 worth of five-year Treasury note futures expiring in three months.
- (1) Investment risk is comparable to the forward transaction above.
 - (2) Cover by segregating \$100 XYZ bond (in an actual transaction, part of the coverage would go to initial margin and the remainder would be placed in a segregated account).
 - (3) Futures agreements and Rule 4.5 notices needed; daily variation margin settlements must be handled; counterparty risk minimal.
- d. Using options, the Fund could buy a three-month at-the-money call on a \$100 five-year bond (or note future) and write a three-month at-the-money put on a \$100 five-year bond (or note future).
- (1) Both the call and the put are needed to replicate ownership of the underlying bond. The call provides exposure only to price changes above \$100, and the cost of the premium dampens the effect of price changes (as a rule of thumb, an at-the-money option returns 50 cents for each \$1.00 change in the underlying). The written put provides downside exposure below \$100, and the premium received pays for buying the call.
 - (2) Cover written put by segregating \$100 XYZ bond; no coverage required for purchased call.

- (3) Options agreements needed; up to entire value of \$100 XYZ bond will be deemed illiquid if OTC contracts used; cash will be needed in three months; counterparty risk slightly greater than forward purchase. If OTC or listed options are used, SEC is the regulator; if options on futures are used, CFTC is the regulator.
- e. Using hybrids, the Fund could sell the \$100 XYZ bond and buy a \$100 five-year inverse floater giving twice the interest rate exposure. The inverse floating coupon would equal two times five-year rates (say, two times 5%, or 10%) minus one times a floating rate (say, six-month commercial paper rates).
- (1) The coupons on the inverse floater give the Fund the right, in essence, to receive two 5% fixed coupons for five years, less a floating interest rate. Except for credit risk on the principal, the investment risk is comparable to buying a \$100 5% bond, then borrowing \$100 at a six-month floating rate and buying another 5% bond with the proceeds. Thus, if five-year bond prices move 1%, the price of the inverse floater should move about twice that amount.
 - (2) Cash flows from inverse floater also are nearly identical to holding the XYZ Bond and entering into a five-year interest rate swap under which the Fund would receive 5% and pay six-month floating rates.
 - (3) No coverage required -- note is "self-covered" since loss is limited to amount invested.
 - (4) No special agreements needed; liquidity issues same as any other security; no counterparty risk (but 100% of value is exposed to credit of inverse floater issuer); coupon characteristics may raise issues for SEC yield and accounting purposes, and may need special handling operationally.

F. Special risks encountered when using derivatives

1. Leverage risk -- a derivative is structured to produce a substantial value change in proportion to the initial cash invested, thereby magnifying the risk of loss as well as the potential gains.
2. Basis risk -- a derivative does not react the same as the related or comparable cash market position. It also may not react the way risk/return or other mathematical models predict due to the interference of variables that were inadequately considered in the models.

3. Complexity risk -- even the simplest derivatives are unfamiliar instruments to many people within an organization and it is important they receive the necessary training to understand them.

G. Traditional risks applicable to derivatives

1. Credit risk
 - a. An exchange traded contract is settled through the clearing facilities of the exchange on which it traded but a loss of initial margin (good faith deposit) and a delay in closing may result if the future commission merchant (FCM) fails financially.
 - b. An over-the-counter contract is settled directly with the counterparty. While counterparty risk is not qualitatively different from traditional credit risks, it may be harder to measure.
2. Market risk -- the values of derivatives change daily in relation to the values of the underlying currencies, commodities or securities.
3. Analysis of both market and credit risks is part of the usual investment decision process for traditional investments.

II. LEGAL ISSUES

A. Investment objectives and policies of an investment company

1. The ability of an investment company to utilize derivatives must be assessed in light of its investment objectives and policies, particularly its statement of fundamental investment policies.
2. Among the fundamental policies that must be considered are those pertaining to the issuance of senior securities, borrowing or lending money, and the right to invest in commodities.
3. In formulating fundamental policies, keep as much flexibility as possible to accommodate new types of derivatives and new strategies that continue to evolve since fundamental policies cannot be changed without shareholder approval, which is an expensive process.
 - a. One way would be instead of using language such as "the right to invest in commodities (futures) for hedging purposes as described in the prospectus" state "purchase or sell commodities or commodity contracts (futures) for any purposes consistent with the investment company's investment objective and to any extent permitted by applicable law."

Otherwise, the policy may be deemed to be that stated in the prospectus at the time the policy was adopted.

b. Another way would be to not make the policy fundamental.

4. Most investment companies construe their investment policies narrowly. For example, a prohibition on short selling will not prohibit writing a call option on securities the investment company does not own.

B. Commodity pools -- are regulated by the CFTC. However, CFTC Rule 4.5 exempts investment companies and their principals (including investment advisers) from registration and regulation as a "commodity pool operator" if they

1. File notice of eligibility with CFTC; must be filed prior to conducting commodities operations and is effective on filing.
2. Undertake to limit initial margin and premiums on commodity futures and options on commodity futures that are not "bona fide hedging" to 5% of net assets.
3. Represent the investment company has not and will not be marketed as a commodity pool or trading vehicle for commodity futures or commodity options.
4. Undertake to disclose to potential investors the purpose and scope of intended trading in commodity futures and commodity options.
5. "Bona fide hedging" is defined by CFTC Rule 1.3(z)(1) to be the taking of a position in a commodity futures contract on any contract market, or in a commodity futures option, where the transaction is for the purpose of offsetting price risks incidental to commercial cash or spot transactions in the underlying items and where the position is taken and liquidated in an orderly manner.
6. The ability to use up to 5% of an investment company's net assets for initial margin on futures contracts and premiums for options on such contracts without offsetting positions could allow leverage of a portfolio far beyond what is permitted by the SEC and state regulations called blue sky laws.

C. Senior securities -- may not be issued by investment companies under Section 18(f) of the Investment Company Act except by borrowing money subject to coverage by assets three times the amount of the borrowing. Although derivatives may or may not constitute "securities," the SEC has generally reasoned from this section (and from Section 1(b)(7)'s concerns regarding speculation) that derivative transactions involving leverage should be controlled by setting aside certain assets.

1. "Leverage," in this context, means an investment company being put into a position where it might owe another party money, not where an investment company has an economically leveraged return.
2. Buying calls, for example, can increase economic leverage, but raises no senior securities questions because the investment company cannot lose more than it invested.
3. Writing calls, on the other hand, may raise senior securities issues because the investment company might have to make payments to the other party if the option moves against it.
4. Coverage requirements are set forth in Release IC-10666 (April 18, 1979, CCH paragraph 48,525) which is the fundamental expression of SEC coverage requirements for derivative transactions, building on the guidelines for Form N-8B-1 (CCH paragraph 51,301, adopted in Release IC-7221, June 9, 1972). Release 10666 requires investment companies to set aside "liquid assets, such as cash, U.S. government securities or other appropriate high grade debt obligations" in a "segregated account" to cover certain types of transactions.
 - a. For forward purchases ("firm commitment agreements"), investment companies should segregate an amount equal to the purchase price to be paid.
 - b. For written put options ("standby commitment agreements"), investment companies should segregate an amount equal to the amount the investment company would be required to pay upon exercise.
 - c. Slightly different segregation standards for currency forward contracts are found in the Guide 23 to Form N-1A: funds should segregate to cover contracts used "to cover activities which are essentially speculative" (usually construed as contracts to purchase foreign currency or to sell currency for non-hedging purposes).
 - d. Structured notes ordinarily are not subject to segregation requirements (unless they are purchased on a forward basis), because an investment company's loss is limited to the amount invested.
5. Coverage of options and futures also was described in a number of identical no-action letters issued by the SEC (e.g., Putnam Option Income Trust II, pub. avail. September 23, 1985).

- a. Futures sold to hedge a portfolio need no segregated account coverage, but should not exceed the value of the investment company's portfolio adjusted for relative volatility of the portfolio and the contracts used to hedge.
- b. Written calls need no segregation if they are covered; otherwise, they are subject to the Form N-8B-1 guidelines (i.e., they must be covered by purchasing an offsetting option or by segregating an amount equal to the market price of the underlying securities).
- c. Purchased futures should be covered by segregating an amount equal to the total market (or underlying) value of the contract, less initial margin deposits.
- d. Written puts should be covered like "standby commitment agreements" under Release 10666, or otherwise as allowed by the Form N-8B-1 guidelines (which permit coverage with an offsetting purchased option or a corresponding short sale).
- e. Important no-action letters since 1985 address ways that segregation requirements can be reduced if an investment company holds offsetting positions in other derivatives (e.g., a purchased put limiting risk on a long futures contract). See Dreyfus Strategic Investing & Dreyfus Strategic Income, pub. avail. June 22, 1987, and Hutton Options Trading L.P., pub. avail. February 2, 1989. In principle, these letters try to limit segregation requirements to the maximum amount the investment company has at risk.
- f. Another no-action letter, Sanford C. Bernstein Fund, Inc. (pub. avail. June 25, 1990) concludes that a written put covered by the identical security on which the put was written would not adequately meet the segregation standards of Release 10666.

D. Margin requirements -- are subject to Section 17(f) of the Investment Company Act which requires an investment company to place and maintain its assets only with qualified banks and brokers. A FCM may not function as an investment company's custodian. The SEC, however, has given "no-action" responses that permit

1. Initial margin to be held in a custodial account maintained at the investment company's custodian in the FCM's name. Initial margin deposits may not be made directly with the FCM.
2. Variation margin payments due to the investment company can be accumulated and held by the FCM provided they are for a de minimis amount (i.e., the lesser of \$50,000 or 1/8%).

III. INVESTOR INFORMATION

A. Prospectus requirements

1. Item 4 Form N-1A -- requires a discussion of how an investment company proposes to achieve its investment objective, a short description of the types of securities in which it will invest and of any particular techniques it will use in doing so, and a concise description of significant investment techniques and policies pertaining to such things as risk arbitrage, repurchase agreements, and forward delivery contracts; but if less than 5% of net assets are at risk, then prospectus disclosure may be limited to identifying the techniques.
2. Guide 21 Guidelines for Form N-1A -- notes that the principal speculative or risk factors associated with an investment must be disclosed.
3. Generic comment letter, February 22, 1993 -- states that although investment companies have been encouraged to abbreviate prospectus disclosure pertaining to derivatives, pertinent risk disclosure is required. For purposes of determining if more than 5% of net assets are at risk, investment companies should look at the potential liability or loss that may be incurred "in connection with a particular practice."

B. Statement of Additional Information (SAI)

1. Investment companies describe investment policies in the SAI that are not otherwise described in the prospectus.
2. Investment companies may reserve freedom of action with respect to activities under investment policies but shall express definitively in terms of a reasonable percentage of assets to be devoted to such activities or in terms of the maximum extent to which they will engage in such activities.

C. Blue Sky Laws

1. Some of the states have specific rules pertaining to the use of certain types of derivatives.
2. Other states require disclosure about specific derivatives.

IV. COMPLIANCE

- #### **A. Liquidity** -- No more than 15% of the net assets of an investment company may be invested in assets that are illiquid (Guide 4 to Guidelines to Form N-1A).

1. Derivatives not traded on exchanges are often considered illiquid. One exception is that the investment company may treat as illiquid only the portion of the repurchase price of a written OTC option that exceeds the amount by which the option is "in-the-money," if the investment company has the right to buy out the option on not more than seven days' notice at a predetermined price (typically, a penalty formula price based on a multiple of premium received plus amount "in-the-money").
2. Derivatives issued by government agencies composed of stripped bonds backed by fixed rate mortgages may be deemed liquid if they can be disposed of promptly in the ordinary course of business at a value reasonably close to that used to calculate the net asset value per share.

B. Pricing -- An investment company prices assets daily so under certain market conditions, pricing a derivative presents unique issues.

1. Exchange traded derivatives have limits on the amount prices may change during a day. When the limit up or limit down has been exceeded, the investment company must decide to price at the limit or on some other basis.
2. Over-the-counter derivatives are opened and closed through the same dealer; however, if the bid/ask spreads become extremely wide, a question arises whether the previously established pricing method such as the bid, ask or mean between the two is the appropriate price.

C. Operational risks -- Recordkeeping systems and operating policies of investment advisers employing the use of derivatives for investment companies must be more elaborate since multiple actions must be taken to initiate and conclude most investment programs involving derivatives. Some of the operational risks include

1. Failure to close offsetting positions. Accordingly, systems must be in place to coordinate all facets of each investment program.
2. Failure of personnel to understand a derivative. Often this results in inaccurate recording for accounting, improper handling for taxes and incorrect instructions to the custodian.

D. Diversification -- Diversified investment companies should evaluate whether particular derivatives constitute "securities" subject to the diversification requirements of Section 5(b)(1) of the ICA and, if so, what entity constitutes the "issuer" of the derivative and the value to ascribe to the derivative as a percent of total assets.

1. When testing diversification under Subchapter M of the Internal Revenue Code, the issuer of the underlying instrument of a derivative is ordinarily considered the "issuer," although most hedging contracts are disregarded for this purpose.

2. SEC treatment of derivatives may differ from IRS treatment, and may consider the counterparty the "issuer" (see, for example, Dreyfus Capital Growth Fund, pub. avail. September 16, 1992, treating a cash-settled option as a debt security of a broker for purposes of Rule 12d3-1).
 3. Regardless of diversification technicalities, investment companies should adopt adequate risk management policies addressing both counterparty risk and exposure to instruments underlying the derivatives.
- E. Suitability** -- The investment risk should be consistent with the expectations of investors. For example, if the name of the investment company designates a specific type of investment, such as IMA Bond Fund, the extensive use of structured notes based on stock indices may not be appropriate.
- F. Steps before using derivatives**
1. Investment department's capabilities
 - a. Review quantitative analysts' knowledge and experience.
 - b. Determine ability to model and the extent testing had been done on the models.
 - c. Devise monitoring procedures, establish appropriate constraints and implement monitoring procedures.
 2. Legal department's responsibilities
 - a. Review terms of derivatives.
 - b. Check disclosure.
 - c. Determine if all compliance requirements have been met.
 3. Accounting and tax departments' duties
 - a. Consider how derivatives are to be priced daily.
 - b. Determine requirements of Internal Revenue Code, book-to-tax differences, mark-to-markets, straddles, income accruals.
 - c. Analyze ways to handle unique issues, negative income, returns of capital.
 4. Custodian's needs

V. DIRECTOR OVERSIGHT

- A. Understanding derivatives** -- Board must understand the intended uses for derivatives, have a general understanding of how derivatives work, know how the intended uses further the investment objective of the investment company, and what the possible pitfalls are.
- B. Knowing the adviser's capabilities** -- Board should be informed of the investment adviser's experience in and capabilities to use derivatives and what procedures are in place to assure no deviation from the intended purposes.
- C. Approving the parameters** -- Board should approve the parameters for using derivatives and review the disclosure set forth in the prospectus.
- D. Monitoring the results** -- Board should expect the investment adviser to evaluate its efficacy in using investment derivatives, and whether investment strategies and techniques involving derivatives helped in achieving the investment company's objective.