

Closed-End Funds  
Special Report

# Closed-End Funds: Evolving Use of Leverage and Derivatives

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**Related Research**

**Applicable Criteria**

- *Closed-End Funds: Fitch Clarifies Criteria for Make-Whole Amounts and Other Prepayment Obligations, March 18, 2010*
- *Closed-End Fund Debt and Preferred Stock Rating Criteria, Aug. 17, 2009*

**Other Research**

- *Closed-End Funds: Redemptions Provide Some Liquidity to Illiquid ARPS Market, Aug. 31, 2010*
- *Credit Derivatives and Margin: Under the Radar?, Aug. 11, 2010*
- *Derivatives: A Closer Look at What New Disclosures in the U.S. Reveal, July 22, 2009*
- *A Brief Review of "The Basis", Jan. 10, 2008*

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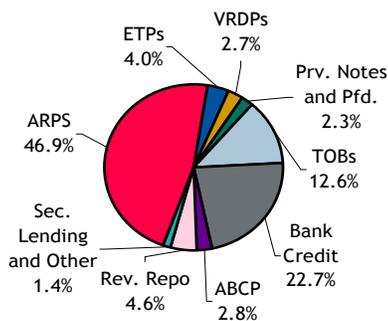
**Summary**

Many closed-end funds (CEFs) utilize leverage such as bank loans, debt, or preferred stock to enhance yields and returns for their common shareholders. Additionally, CEFs may also utilize various types of derivatives to meet their investment objectives either for purposes of hedging or as means to more efficiently achieve return and leverage targets (economic leverage). While leverage strategies enhance equity returns in favorable markets with rising asset returns and positively sloped yield curves, leverage may also amplify the downside risk to debt, preferred stock, and common stock investors in less favorable markets.

This report discusses the use of leverage and derivatives by CEFs and some of the key issues investors should consider when evaluating CEFs. Report highlights include:

- Based on financial statements publicly filed on or before July 30, 2010, 416 U.S. leveraged CEFs had issued \$55.4 billion of cash-funded leverage against \$180.4 billion in assets under management.

**Cash-Funded Leverage Types Utilized by U.S. CEFs**  
(As of July 30, 2010)



Note: Numbers may not add due to rounding.

**Cash-Funded Leverage Types Utilized by U.S. CEFs**

Type	Description
ARPS	Auction-rate preferred shares
ETPs	Exchange traded preferred shares
VRDPs	Liquidity-backed demand preferred shares
Prv. Pfd.	Privately placed preferred shares
Prv. Notes	Privately placed notes
TOBs	Notes issued by tender option bond trusts
Bank Credit	Credit facilities from financial institutions
ABCP	Credit facilities from ABCP conduits
Rev. Repo	Reverse repurchase agreements
Sec. Lending and Other	Securities lending arrangements and securities sold short

- Additionally, 71 Fitch-rated CEFs were using a notional amount of \$4.7 billion in derivatives for economic leverage and, to a lesser extent, for hedging.
- Nontraditional forms of “economic leverage” via derivatives may alter a CEFs risk profile relative to traditional forms of leverage in ways that are not always captured within the current regulatory framework’s limits on leverage. This can be particularly true for more volatile asset types.
- The SEC is reviewing the use of derivatives by registered funds, and the American Bar Association (ABA) recently published recommendations to this effect.
- An important consideration with respect to a fund’s use of derivatives is whether such derivative exposure is used for hedging purposes or for economic leverage, as this may affect the degree to which noteholders are exposed to additional risk.

- Fitch incorporates nontraditional leverage in its rating analysis of CEF debt and preferred stock by effectively “grossing up” the CEF balance sheet for all forms of leverage, whether they be in traditional cash forms or in nontraditional off-balance sheet derivatives.
- An appropriate “risk-adjusted” view of leverage, whether traditional or nontraditional, should also consider the potential differences in the price volatility of different asset types.

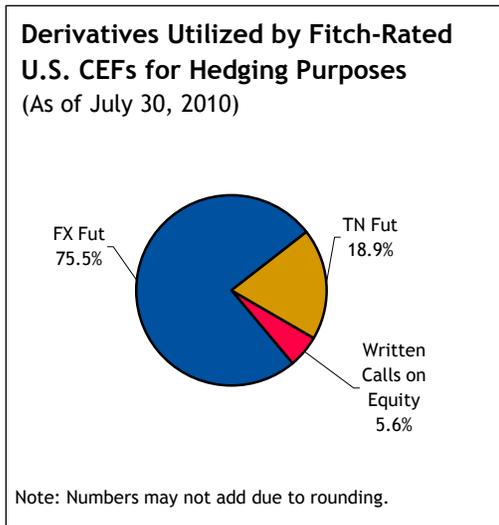
### Derivative Usage by U.S. CEFs

As one way to efficiently manage and modify portfolio risk, CEFs at times utilize derivative instruments for hedging as well as economic leverage. In Fitch’s opinion, derivatives can be an effective tool for CEFs to manage existing risks and/or take on new risk exposures, provided that the marginal risk contribution is appropriately identified and measured.

Detailed public information on most derivative activity undertaken by CEFs is limited in nature and inconsistent in form. As such, it is difficult to make general statements regarding the magnitude of CEF derivative activity based on publicly available financial statements. That said, with respect to CEFs rated by Fitch, additional information regarding the size, type, and terms of derivative activities is requested and factored in to Fitch’s analysis. As of July 30, 2010, 71 CEFs with Fitch-rated liabilities utilized \$4.7 billion in notional amount of derivatives, consisting of \$4.0 billion used for leverage purposes and \$700 million used for hedging (*see charts and tables below for detail*).

### Derivatives for Hedging Risk Exposures

CEFs may utilize a number of different derivatives to hedge credit, currency, interest rate, and/or market risk exposures associated with the fund’s investment portfolio and existing derivative positions, as well as interest rate risk exposures associated with the fund’s leverage. These strategies and the most common instruments that portfolio managers use to achieve them are summarized in Appendix 1 on page 8.



### Derivatives Utilized by Fitch-Rated U.S. CEFs for Hedging Purposes

Type	Description
FX Fut	Currency futures short
TN Fut	U.S. Treasury note futures short
Written Calls on Equity	Written call options on stock

### Derivatives Used for Economic Leverage

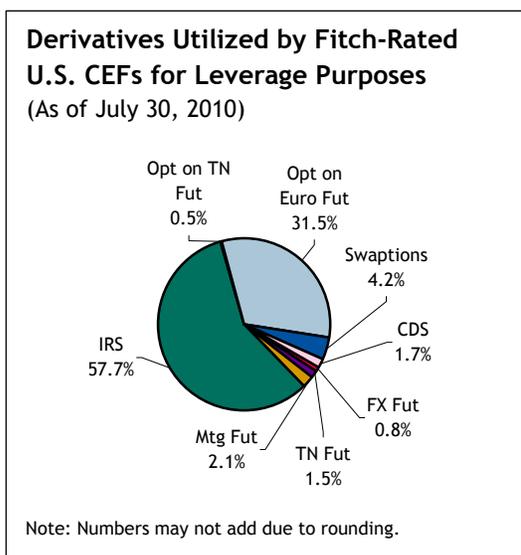
Although CEFs have traditionally utilized cash-based leverage, over the last several decades, CEFs also have begun to use derivatives to assume certain risk exposures on a synthetic basis, such as credit, interest rate, and currency risks.

Among the reasons why portfolio managers may elect to utilize derivatives instead of

cash market securities for leverage are:

- **Difficulty in “Sourcing” Investment Assets or Risk Exposures:** When desired securities or risk exposures are not readily available in the cash markets, it may be easier for a fund manager to obtain exposure by utilizing derivatives.
- **Greater Liquidity, Lower Transaction Costs, and Better Price Transparency:** The ease of execution, lower bid/ask spread, and price transparency all may be superior to that found in the cash market. For example, a portfolio manager may enter into a CDS position to assume credit risk as opposed to purchasing the reference security.
- **Reduced Funding Costs:** Depending on margin requirements, lower funding costs may also provide an incentive for CEFs to utilize derivatives in assuming leveraged asset exposure.

The most common types of derivative instruments that portfolio managers utilize to achieve various leverage objectives are summarized in Appendix 2 on page 9.



**Derivatives Utilized by Fitch-Rated U.S. CEFs for Leverage Purposes**

Type	Description
Opt on Euro Fut	Written put options on long Eurodollar futures
Swaptions	Written put and call options on interest rate swaps
CDS	Credit default swaps long and short
FX Fut	Currency futures long and short
TN Fut	U.S. treasury note futures long
Mtg Fut	Mortgage dollar rolls
IRS	Interest rate swaps, includes long and short
Opt on TN Fut	Written put and call options on U.S. Treasury note futures

**Leverage and Derivatives – Treatment and Regulatory Limits**

**Regulatory Treatment**

The Investment Company Act of 1940 (the 1940 Act) and subsequent publications by the SEC outline the maximum amounts of leverage that regulated U.S. CEFs may undertake. By regulation, the amount of leverage that CEFs may assume is limited to 33% of assets in the case of senior debt and 50% of assets in the case of preferred stock.

In the case of economic leverage using certain noncash-settled derivatives, CEFs are limited to 100% of assets and must segregate assets in amount equal to the notional value of the derivative contract. However, for certain cash-settled derivatives, the regulatory leverage restrictions are less conservative, as the fund is only limited by broker’s initial margin (if any) and mark-to-market posting requirements, which may be low at the outset. The table on top of next page outlines the major categories of SEC-mandated leverage limits currently in effect.

In the case of derivatives used strictly for hedging, the SEC announced in a 1987 no-action letter that a fund may first net out other offsetting positions before determining the net amount of collateral a fund must segregate to cover the utilized derivative positions. For example, if a fund holding a diversified portfolio of investment-grade corporate bonds

purchases protection via a credit default swap that references an investment-grade corporate bond index and fully offsets the cash exposure, the fund, subject to the interpretation of its auditors and board of directors, may not need to segregate assets for regulatory purposes. A similar interpretation has been made by fund auditors and boards of directors for cash-settled derivatives, where funds would net the mark-to-market amounts on similar offsetting derivatives before determining the amount of assets that must be segregated for any net market-to-market amount. An example of this would be

## Overview of Regulatory Treatment for Leverage and Derivatives Utilized by CEFs

Leverage Type	SEC Treatment
Preferred Stock	200% minimum asset coverage
Notes and Credit Facilities <sup>a</sup>	300% minimum asset coverage
Cash-Settled Derivatives <sup>b</sup>	Segregate assets in amount at least equal to the daily mark-to-market obligation on the position
Other Noncash-Settled Derivatives	Segregate assets in amount at least equal to the reference asset market value, which is equivalent to 100% asset coverage. <sup>c</sup>

<sup>a</sup> Includes bank lines, commercial paper conduit, among other types. <sup>b</sup> Directly held money market futures, options on money market futures, interest rate swaps, and others. <sup>c</sup> This treatment is currently informal.

to net long interest rate swaps against short interest rate swaps.

### Leverage with Cash-Settled Versus Noncash-Settled Derivatives

The 1979 SEC report titled “Investment Company Act Release No. 10666” set forth similar leverage limitations for noncash-settled derivatives, such as credit default swaps, as the Investment Company Act of 1940 did for traditional leverage, such as preferred stock. The report published guidelines that noncash-settled derivatives utilized by funds may be exempt from SEC’s asset coverage requirements, as long as funds segregate eligible assets in an amount at least equal to the referenced market value exposure underlying the derivative contracts. Similar to the regulatory guidelines applicable to preferred stock leverage, the guidelines applicable to noncash-settled derivatives effectively result in a maximum economic leverage limit of 2.0x the funds’ equity.

However, when funds utilize cash-settled derivatives, such as interest rate futures, interest rate swaps, and options on interest rate futures and interest rate swaps, a much higher leverage amount may be assumed by the fund while still satisfying SEC guidelines. This is because the SEC guidelines only require accounting for any negative mark-to-market on cash-settled positions, as opposed to the full notional amount.

Consider an example of a hypothetical CEF with \$250 million in assets under management. If this fund utilizes only traditional leverage, such as preferred stock, it would be limited to \$125 million in leverage given the SEC’s 200% minimum asset coverage test (*see Cash-Funded Capital Structure column in the table on the top of page 5*). However, the same fund could achieve \$250 million in total leverage if it also employed \$125 million notional amount of a cash-settled derivative, such as a fixed-rate receiver interest rate swap. To achieve this, per current SEC guidelines, the fund would need to only segregate assets for any negative mark-to-market on the cash-settled position as opposed to the full notional amount.

On April 17, 2009, the SEC’s then-current Director of Investment Management, Andrew Donohue, gave a speech (a transcript of which the SEC subsequently published) about the extent to which derivatives are being increasingly utilized by investment companies. Donohue voiced concern about the adequacy of the SEC’s regulation of the use of derivatives, as well as the adequacy of disclosures to investors, and called on the ABA to recommend changes on certain regulatory provisions. On July 6, 2010, the ABA responded by publishing a report titled “Report of the Task Force on Investment Company Use of Derivatives and Leverage,” in which the ABA cited a number of recommendations, such as formalizing cash-settled derivatives treatment and

establishing asset segregation requirements based on relevant risk factors attributable to each derivative instrument (*for more information on the ABA's report and other*

**CEF Capital Structure Examples Based on Leverage Forms Utilized**

Cash-Funded Capital Structure		Cash-Funded and Derivatives-Based Capital Structure	
Assets	Leverage and Equity	Assets	Leverage and Equity
\$250 million cash assets	\$125 million preferred stock \$125 million common equity	\$250 million cash assets \$125 million of synthetic interest rate assets	\$125 million preferred stock \$125 million notional amount of interest rate swaps <sup>a</sup> \$125 million common equity

• **Leverage Amount:** Fund equity is 2.0x leveraged

• **Leverage Amount:** Fund equity is 3.0x leveraged

• **Leverage Effect on Returns:** 5% increase/(decrease) in asset prices may result in a 10% increase/(decrease) in net asset value (NAV).

• **Leverage Effect on Returns:** 5% increase/(decrease) in asset prices may result in a 15.0% increase/(decrease) in NAV.<sup>b</sup>

<sup>a</sup>This example assumes that the derivative counterparty does not demand any initial margin on the position. Fitch understands that the industry practice for margin postings as a percentage of the notional amount by 1940 Act CEFs is close to zero. However, the margin is always required for any net negative mark-to-market on the derivatives contracts. <sup>b</sup>This calculation uses hypothetical returns/(losses) from performance of the portfolio's cash and synthetic interest rate assets.

*regulatory updates, see Appendix 3, page 10).*

**Fitch's Treatment of Derivatives**

Fitch's treatment of derivatives used by CEFs for economic leverage differs from the regulatory treatment in certain instances. Conceptually, Fitch looks through to the referenced assets/risk exposures and grosses up the balance sheet and leverage measures to replicate the amount of leverage as if the position had been cash funded.

In the case of derivatives used as hedges, Fitch views these in a fashion similar to their regulatory treatment, provided they clearly offset existing risk exposures. This is accomplished by reflecting the market-to-market gain or loss on the derivative in the Fitch calculation of the fund's asset coverage as an offset against any gain or loss on the hedged exposure.

Additionally, Fitch evaluates counterparty risk arising from funds' over-the-counter derivative positions when assigning ratings to CEF liabilities. This evaluation also applies to certain securities lending arrangements, where the securities lent are handled by the same counterparty that retains the cash collateral received. Significant exposure to lower rated or nonrated counterparties may have negative rating implications. For more information, see Fitch Research on "Counterparty Criteria for Structured Finance Transactions," dated Oct 22, 2009, available on Fitch's Web site at [www.fitchratings.com](http://www.fitchratings.com).

**Differentiating Riskiness by Underlying Asset Type**

Fitch notes that the current regulatory framework for CEFs treats all leverage equally from a risk perspective and does not adjust for potential differences in the price volatility of various asset classes. This may be appropriate for assets that historically have exhibited low price volatility, such as government securities and municipal bonds. In such cases, the regulatory limits on leverage, combined with certain structural protections, may be more than adequate. However, for more volatile asset classes, further adjustments may be appropriate.

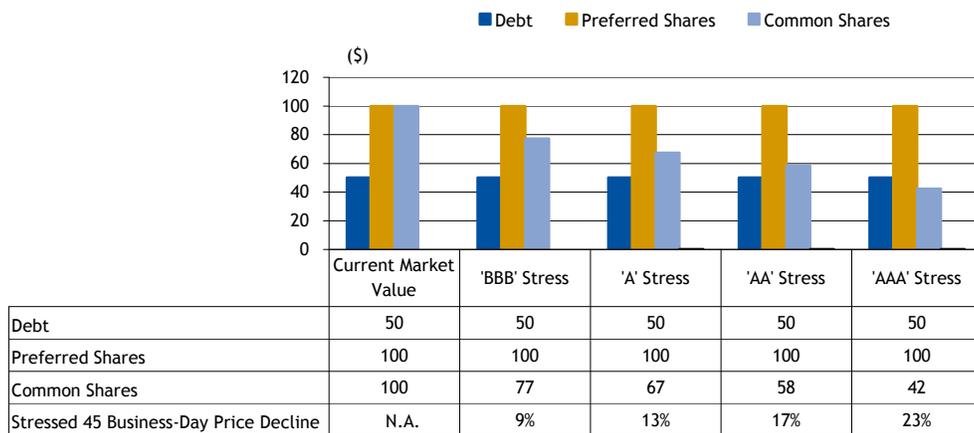
When rating CEF debt and preferred stock and evaluating CEF leverage, Fitch takes into consideration the CEF's investment strategy and the potential price volatility of assets. As such, Fitch's view of the sufficiency of asset coverage supporting rated obligations varies depending on the fund's investments.

Consider that the aforementioned hypothetical fund invests its \$250 million of assets in either 'AA' rated intermediate-term corporate bonds or large capitalization equity securities (*see charts on page 6*).

**Corporate Bond Portfolio**

Based on the hypothetical portfolio and capital structure in the chart at right, a full recover is realized for the debt and preferred share investors under all price stress scenarios. At the bottom the capital structure, common shareholders would be expected to absorb losses ranging from 23% in a 'BBB' price stress ( $[\$77 - \$100]/\$100$ ) to 58% in an 'AAA' price stress ( $[\$43 - \$100]/\$100$ ).

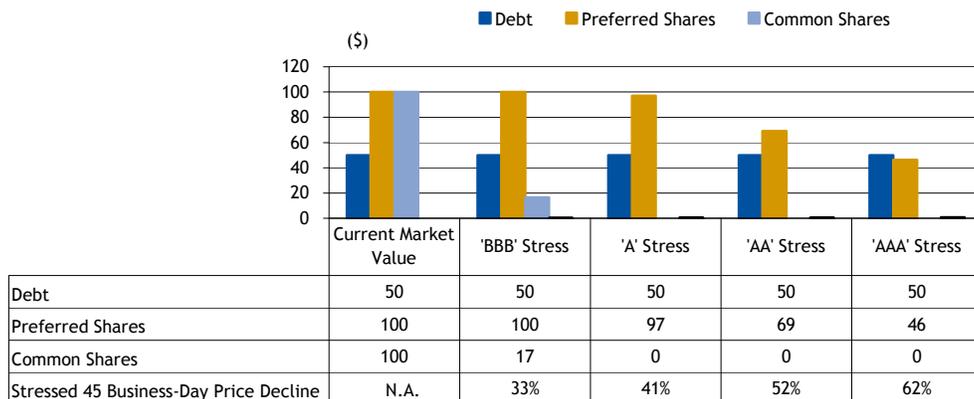
**Hypothetical Corporate Bond Portfolio and Capital Structure: Recovery Expectations in Various Stress Scenarios**



**Equity Portfolio**

Based on the hypothetical portfolio and capital structure in the chart at the right, a full recovery is realized for the debt investors under all price stress scenarios. However, lower in the capital structure, the preferred share obligations would be expected to absorb losses ranging from 3% in 'A' price stress ( $[\$97 - \$100]/\$100$ ) to 54% in an 'AAA' price stress ( $[\$46 - \$100]/\$100$ ). At the bottom of the capital structure, common shareholders would be expected to absorb losses ranging from 83% in a 'BBB' price stress ( $[\$17 - \$100]/\$100$ ), to 100% in 'A', 'AA' and 'AAA' price stresses ( $[\$0 - \$100]/\$100$ ).

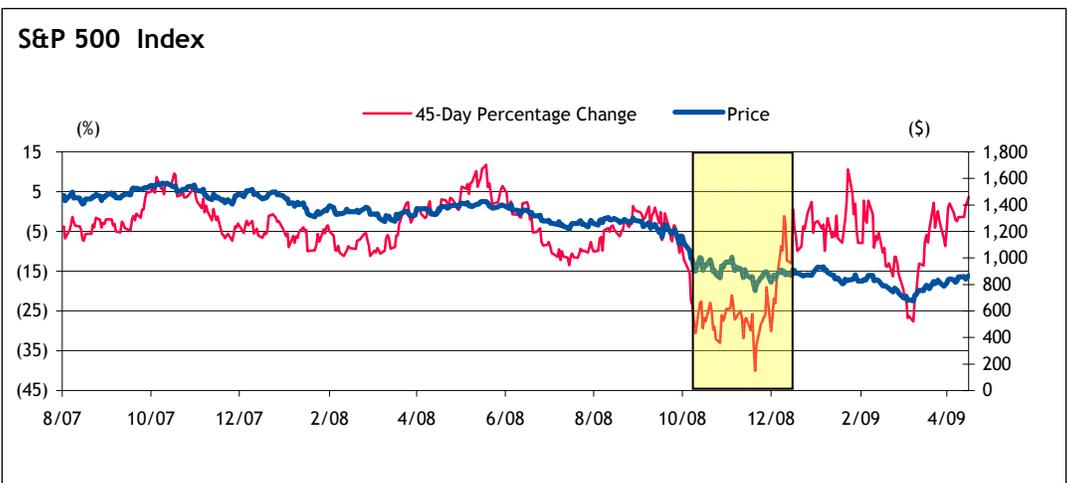
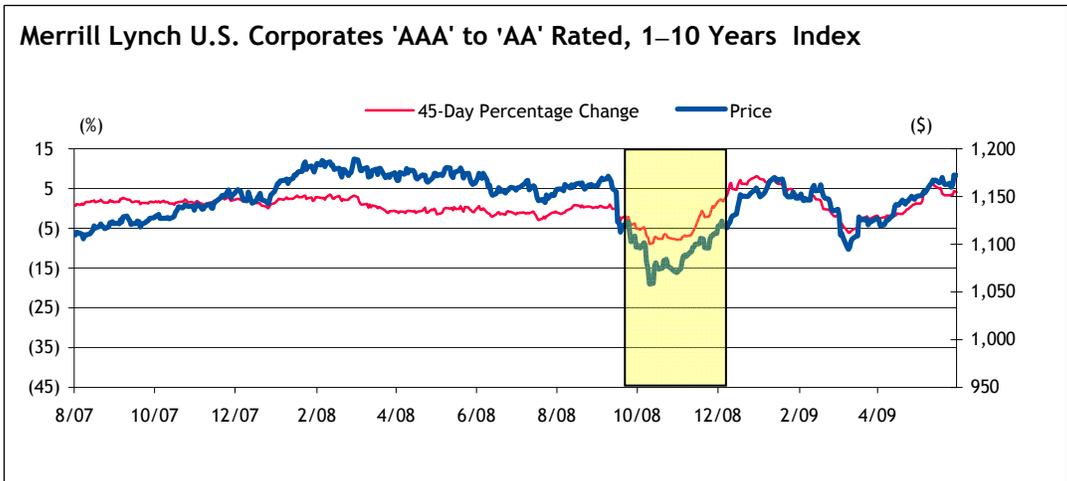
**Hypothetical Equity Portfolio and Capital Structure: Recovery Expectations in Various Stress Scenarios**



The examples above highlight that, in times of market stress, potential losses experienced by fund investors may be exacerbated depending on the riskiness and price volatility of fund assets, as well as the extent to which the fund undertakes additional cash and/or economic leverage. Conversely, in favorable market conditions, Fitch acknowledges that leverage enhances returns for common shareholders and increases asset coverage for debt and preferred stock investors.

The 45-business day loss expectations used for each asset class, as well as in Fitch's rating criteria, are derived from historically observed worst-case price declines of representative indices and a qualitative liquidity haircut that Fitch expects for funds to realize upon sale. As depicted in the price performance charts of these indices on page 7, the 45 business-day worst market value loss for 'AA' rated intermediate term U.S. corporate bonds was approximately 9%, whereas the 45 business-day worst market value loss for S&P 500 equities was approximately 40%.

Historically Observed 45-Day Worst Losses of or Representative Indices



Appendix 1

Typically Observed Derivatives Used by CEFs for Risk Hedging Purposes

Investment Risks	Hedging Strategies	Description
<b>Credit Risk:</b> Associated with an overall bond portfolio, a bond sector, bond industry, or a specific bond issue	Long credit default swap	<ul style="list-style-type: none"> <li>Hedges against widening of credit spreads</li> </ul>
<b>Interest Rate Risk:</b> Associated with an overall portfolio or liability exposure	Short interest rate swap	<ul style="list-style-type: none"> <li>Decreases duration by paying fixed and receiving floating interest rate</li> </ul>
	Short treasury future	<ul style="list-style-type: none"> <li>Decreases duration by contracting to deliver a treasury note at a predetermined price</li> </ul>
<b>Currency Risk:</b> Associated with investments denominated in foreign currencies	Short currency future or forward	<ul style="list-style-type: none"> <li>Protects against depreciating of foreign currency relative to domestic currency</li> </ul>
<b>Market Risk:</b> Associated with an overall portfolio, a sector of securities or specific securities	Buy inverse index ETFs	<ul style="list-style-type: none"> <li>Protects against decrease in index price</li> </ul>
	Write call options on specific securities	<ul style="list-style-type: none"> <li>Used as part of covered call strategies</li> </ul>

Appendix 2

Typically Observed Derivatives Used by CEFs for Economic Leverage

Main Investment Views	Leverage Strategies	Description
<b>Credit:</b> Associated with an overall bond portfolio, a bond sector, bond industry, or a specific bond issue	Short or long credit default swaps	<ul style="list-style-type: none"> <li>Express a view on direction and movements, or lack thereof, of credit spreads</li> </ul>
<b>Interest Rate:</b> Associated with an overall portfolio or liability exposure	Long interest rate swap	<ul style="list-style-type: none"> <li>Increases duration by paying floating and receiving fixed interest rate</li> </ul>
	Long treasury note future	<ul style="list-style-type: none"> <li>Increases duration by contracting to receive a Treasury note for a predetermined price</li> </ul>
	Short straddle/strangle using options on Treasury note futures, interest rate swaps, or swaptions (e.g. writing puts and calls)	<ul style="list-style-type: none"> <li>Express a view that the interest rates referenced in the underlying instrument will not change so much as to appreciate the value of the options in excess of the premiums received</li> </ul>
	Long Eurodollar, Euribor, or U.K. rate future (short-term rates)	<ul style="list-style-type: none"> <li>Increases duration (although only moderately, given the short-term rate exposure) by expressing a view that the referenced rate will not increase by as much as the current market expectation</li> </ul>
	Write put on long Eurodollar, Euribor, or U.K. interest rate futures (short-term rates)	<ul style="list-style-type: none"> <li>Increases duration (although only moderately, given the short-term rate exposure) by expressing a view that the underlying referenced rate will not increase so much as to appreciate the value of the put options in excess of the premiums received</li> </ul>
<b>Currency:</b> Associated with investments denominated in foreign currencies	Long currency future/forward	<ul style="list-style-type: none"> <li>Express a view on direction and movement of foreign currency relative to domestic currency</li> </ul>
<b>Market:</b> Associated with an overall portfolio, a sector of securities, or specific securities	Long Index/security future or forward	<ul style="list-style-type: none"> <li>Express a view on appreciating market price</li> </ul>
	Write put option on index ETFs	<ul style="list-style-type: none"> <li>Express a view that index price will not fall below strike price relative the option premium received</li> </ul>
	Long Index ETFs	<ul style="list-style-type: none"> <li>Express a view on increase in index price</li> </ul>
	Long total return swaps	<ul style="list-style-type: none"> <li>Express a view on increase in reference asset/index</li> </ul>

Appendix 3

Timeline of Relevant Announcements on Regulatory Oversight of Investment Companies' Use of Leverage and Derivatives

Date	Event	Summary
July 30, 2010	SEC letter to Investment Company Institute titled "Derivatives-Related Disclosures by Investment Companies"	<ul style="list-style-type: none"> <li>• SEC staff observed that disclosures on the use of derivatives found in many registration statements of investment companies are often too generic to prove useful for investors in evaluating the funds' investment operations. Staff also found that there is little consistency between the extent of details disclosed on derivative-related risks and the actual amount of derivative use by the funds.</li> <li>• Staff made several recommendations regarding investment companies' current derivative disclosures to ensure accuracy and completeness in comparison to actual operations.</li> </ul>
July 6, 2010	ABA Task Force published report titled "Report to the Division of Investment Management"	<ul style="list-style-type: none"> <li>• The report identifies potential improvements to the existing regulatory framework over the use of derivatives by investment companies. Relevant highlights include:</li> <li>• <b>Asset Segregation:</b> Officially adopt guidelines that certain derivatives, such as cash-settled futures and forwards, would only require asset segregation of daily mark to market value of obligation. Since December 2005, the SEC has recognized this treatment on an informal basis; and differentiates the required amount and type of asset segregation needed based on the riskiness of each derivative, referred to as risk-adjusted segregated amounts (RAS).</li> <li>• <b>Implicit Leverage:</b> Do not expand the application of Release 10666 to all investments that create implicit leverage, including certain types of derivatives and complex securities.</li> <li>• <b>Diversification:</b> Bifurcate derivatives treatment depending on whether the instrument is a security, in which case the funds would count the amount as one issuer, or alternatively if the instrument is not a security, such as Treasury futures, then the funds would not count that amount as one issuer; look to the reference security for issuer diversification purposes, as opposed to the counterparty; and use the market values of reference assets for calculation of the portfolio's diversification but seek comment on the treatment of negative market values.</li> <li>• <b>Counterparty Exposure:</b> Place limitations on the amount of uncollateralized exposure to a single counterparty (excluding exchanges and clearinghouses); and require adequate disclosure.</li> </ul>
March 25, 2010	SEC published a press release entitled "SEC Staff Evaluating the Use of Derivatives by Funds"	<ul style="list-style-type: none"> <li>• Announced a comprehensive review of the use of derivatives by investment companies. May result in revised regulatory treatment. Timeline of further feedback or implementation is uncertain at this point.</li> </ul>
April 17, 2009	Speech by SEC's Director of Division of Investment Management Andrew J. Donohue, titled "Investment Company Act of 1940: Regulatory Gap between Paradigm and Reality?"	<ul style="list-style-type: none"> <li>• An address to the American Bar Association (ABA) that: reviewed SEC's regulatory measures on mutual fund leverage and derivatives taken to date; voiced concern that utilization of derivatives by mutual funds has become more extensive and complex in the last 30 years; voiced concern about the adequacy of SEC's current regulation over the use of derivatives, as well as the adequacy of disclosures to investors; and called on the ABA to recommend changes, if any are needed, on certain regulatory provisions relating to use of derivatives by investment companies.</li> </ul>
Nov. 7, 1997	SEC issued a staff letter to investment company CFOs	<ul style="list-style-type: none"> <li>• Staff declared that it will not object if funds segregate assets solely on the fund's records and not designated on the fund's custodian's records, provided that relevant procedures and controls are undertaken in accordance with the interpretation outlined in Release 10666.</li> </ul>
July 2, 1996	SEC issued a no-action letter to Merrill Lynch Asset Management, L.P.	<ul style="list-style-type: none"> <li>• Staff clarified that other assets such as common stock and lower credit-grade corporate bonds are also eligible as collateral for nontraditional leverage, as long as they are deemed liquid by the fund board of directors/trustees.</li> </ul>
June 22, 1987	SEC Issued a no-action letter to Dreyfus Strategic Investing & Dreyfus Strategic Income	<ul style="list-style-type: none"> <li>• Staff clarified that securities sold short, options purchased and sold on specific securities, forward contracts on currencies purchased and sold, interest rate futures contracts, and other futures contracts are also exempt from the minimum asset coverage test, provided that funds segregate liquid assets in an amount equal to the reference value of those contracts.</li> <li>• Staff also clarified that assets would not need to be segregated for such contracts if the contracts are "covered" by other contracts or positions with offsetting market value exposure.</li> </ul>
April 18, 1979	SEC published "Investment Company Act Release No. 10666 (10666)"	<ul style="list-style-type: none"> <li>• Staff addressed certain forms of derivatives and other nontraditional leverage employed by investment companies, including reverse repurchase agreements, firm commitment agreements, standby commitments, short sales, written options, forwards, and futures.</li> <li>• Defined leverage as "when an investor achieves the right to a return on a capital base that exceeds the investment that he has personally contributed to the entity or instrument achieving a return."</li> <li>• Held that reverse repurchase agreements, firm commitment agreements, and standby commitment agreements may be exempt from asset coverage tests, as long as those contracts are matched by segregated liquid assets in an amount equal to the fund's then-current economic exposure under the contracts. The segregated assets would need to be marked to market daily and held in a readily-accessible custodian account. Liquid assets were originally defined as U.S. government securities and high credit-grade corporate bonds.</li> </ul>
Aug. 22, 1940	SEC published "Investment Company Act of 1940"	<ul style="list-style-type: none"> <li>• Mandated a minimum 200% asset coverage ratio for total outstanding traditional leverage when preferred stock is utilized in the fund's capital structure. Also mandated a minimum 300% asset coverage ratio for total traditional leverage senior to preferred stock. Both ratios are calculated off the portfolio's current market value and are typically tested by the funds on a monthly basis.</li> </ul>

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