March 25, 2016

VIA ELECTRONIC MAIL
Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

RE: File No. S7-24-15, Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Mr. Fields:

On behalf of the U.S. Securities Markets Coalition ("Coalition"),[1] The Options Clearing Corporation ("OCC") appreciates the opportunity to submit these comments on the proposal by the Commission regarding the "Use of Derivatives by Registered Investment Companies and Business Development Companies" (the "Proposal").[2] The Proposal would create new Commission Rule 18f-4 under the Investment Company Act of 1940, as amended (the "Investment Company Act"), to update and provide a more comprehensive approach to the use of derivatives by mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and companies that have elected to be treated as business development companies ("BDCs") under the Investment Company Act (collectively, "funds"). The Coalition understands and appreciates the concerns expressed by the Commission in issuing the Proposal. As described in more detail below, the Coalition is focused on ensuring that certain aspects of the Proposal do not limit the ability of funds to effectively use exchange-traded options ("listed options").

Equity options have been traded on U.S. securities exchanges for over 40 years. The U.S. options exchanges currently offer options on over 3,700 individual stocks, exchange-traded funds, and equity-related indices. In 2015, some 3.7 billion listed options on individual equities were traded on U.S. options exchanges, with each contract typically covering 100 shares of the underlying stock. When listed options on securities indices are included, some 4.1 billion listed options were traded on U.S. options exchanges, or an average of approximately 16.4 million contracts every trading day. Total gross premiums

[1] The members of the Coalition (together with OCC) are BATS Options, BOX Options Exchange, Chicago Board Options Exchange, International Securities Exchange, NASDAQ Options Market, NASDAQ OMX PHLX, NYSE Arca, and NYSE Amex. All of these members are regulated by the Commission, and OCC is also regulated by the Commodity Futures Trading Commission and The Board of Governors of the Federal Reserve.

[2] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), 80 Fed. Reg. 80883 (Dec. 28, 2015) (the "Proposal").

for listed options in 2015 were $1.2 trillion or roughly $4.8 billion per trading day.[3] OCC is the clearing agency for all U.S. options exchanges, and OCC was designated in July 2012 as a systemically important financial market utility by the Financial Stability Oversight Council.

Listed options provide funds with a valuable risk management tool. For instance, listed options provide funds with the ability to hedge downside risk of individual stocks or an entire portfolio through the purchase of put options on stocks or indices. They also provide funds with the ability to generate income by engaging in low-risk strategies, such as writing "covered calls."[4] In addition, listed options provide funds with the ability to engage in risk-limited transactions to gain exposure to individual stocks or indices through strategies such as spread trades.[5] Funds are also increasingly using listed options to manage the risks associated with their securities portfolios, and funds are becoming increasingly important participants in the listed options market. The Coalition is concerned that the Proposal would unduly limit the ability of funds to effectively use listed options.

I. The Proposal Appropriately Excludes Purchased Options From the Definition of "Derivatives Transaction"

The Commission appropriately recognizes that purchased options should not be treated as "derivatives transactions." As the Commission notes in the Proposal, "[a] fund that purchases an option . . . generally will make a non-refundable premium payment to obtain the right to acquire (or sell) securities under the option but generally will not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option," and "[a] derivative that does not impose a future payment obligation on a fund in this respect generally resembles non-derivative securities investments in that these investments may lose value but will not require the fund to make any payments in the future."[6] A purchase of a call or put option by a fund only exposes the fund to the loss of the premium (*i.e.*, the purchase price for the option), and not a future payment obligation. Accordingly, the Coalition agrees that purchased options should be excluded under the final rules.

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[3] The buyer of a call or put option must pay an up-front amount for each option contract known as the "premium."

[4] A call option is considered "covered" if the writer of the option owns the shares underlying the option. Covered calls are discussed in more detail below. A call option on stock conveys to the buyer of the option the right, but not the obligation, to buy a given number of shares (typically 100) of the underlying stock at a specified price (the "strike price") on or before a specified date (the "expiration date"). The buyer of the option must pay an up-front premium for the contract. The seller of the option, which may also be referred to as the "writer" of the option, receives that premium but also becomes obligated to sell the underlying stock to the buyer of the option, at the strike price, should the buyer of the option exercise the option.

[5] Options spreads are the basic building blocks of many options trading strategies. A spread position is entered by buying and selling equal number of options of the same class (*i.e.*, options on the same underlying security) but with different strike prices or expiration dates.

[6] Proposal at 80891.

II. The Proposal Should Exclude "Covered Calls" From the Definition of "Derivatives Transaction," or in the Alternative, the Definition of "Exposure" Should Exclude Exposure With Respect to Covered Calls

Writing covered calls is a common options trading strategy. It is frequently engaged in by market participants that already own large portfolios of securities as a way of generating extra income from those securities, and is widely considered to be a conservative strategy.[7] In a covered call transaction, the buyer of a call option has limited downside and theoretically unlimited upside—*i.e.*, it stands only to lose its premium, but it stands to gain a theoretically unlimited amount if the price of the stock goes up to a level well in excess of the strike price. The writer of a call option that is not a covered call, on the other hand, has limited upside and theoretically unlimited downside—*i.e.*, it stands only to gain the premium, but it stands to lose a theoretically unlimited amount if the price rises to a level well in excess of the strike price.

A writer of a call option may eliminate this downside risk by holding the shares that underlie the option. A writer that owns the underlying shares is considered "covered" and engaging in this strategy is known as "writing covered calls." While such a writer does have a theoretically unlimited risk that the market price of the securities will go up, that risk is entirely offset by the fact that the writer will enjoy the same upside gains on the securities themselves. In other words, an uncovered writer must go into the market (potentially at a very unattractive price) to obtain shares to deliver to the buyer when the option is exercised, while a covered writer can simply deliver the shares that he or she already owns.

We do not believe that covered calls create the same concerns about excessive leverage that are posed by other transactions in derivatives. Although written call options, when viewed in isolation, do expose the fund to a potential future obligation, that obligation will be entirely offset by the covering shares. Accordingly, covered calls should be excluded from the definition of "derivatives transaction" under the Proposal. This could be accomplished in several ways, but we believe the preferred way would be to alter the definition of "Derivatives transaction" under the Proposal and add a definition of "Covered call," each as follows:

> *Derivatives transaction* means any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ("derivatives instrument") under which the fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as a margin or settlement payment or otherwise**; provided that such term shall not include the purchase of a listed option or the writing of a covered call** .

[7] *See, e.g.*, Hemler & Miller, The Performance of Options-Based Investment Strategies: Evidence for Individual Stocks During 2003-2013, http://www.optionseducation.org/content/dam/oic/documents/literature/files/perf-options-strategies.pdf.

> ***Covered call*** **means any listed call option for which the writer of the option holds a number of units of the underlying interest equal to the contract size of the option.**

If the Commission does not exclude covered calls from the definition of derivatives transaction, at a minimum the Commission should modify the definition of "Exposure" to allow a fund to exclude covered calls from its calculation of its exposure for purposes of the 150% and 300% portfolio limitations under the Proposal. Again, this could be accomplished in several ways, including altering the definition of "Exposure" under the Proposal and adding a definition of "Covered call," each as follows:

> *Exposure* means the sum of the following amounts, determined immediately after the fund enters into any senior securities transaction:
>
> (i) The aggregate notional amounts of the fund's derivatives transactions **that are not covered calls**, provided that a fund may net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms;
>
> (ii) - (iii) * * *
>
> ***Covered call*** **means any listed call option for which the writer of the option holds a number of units of the underlying interest equal to the contract size of the option**.[8]

III. The Proposal Should Be Harmonized With Other Rules Applicable to Listed Derivatives

As drafted, the Proposal does not reflect the substantial differences between listed derivatives and over-the-counter derivatives. We believe the Proposal should be modified in several respects in order to take account of these important differences, particularly as they relate to listed options. OCC is the central counterparty for all U.S. options exchanges and acts as the buyer to every seller and the seller to every buyer with respect to listed options in the United States.

a. Funds Should Be Deemed to Be in Compliance With Proposed Rule 18f-4(a)(2) With Respect to Listed Derivatives

Proposed Rule 18f-4(a)(2) would require a fund to "manage[] the risks associated with its derivatives transactions by maintaining qualifying coverage assets, identified on the books and records of the fund as specified in paragraph (a)(6)(v) of this section and determined at least once each business day, with a value equal to at least the sum of the fund's aggregate mark-to-market coverage amounts and risk-based coverage amounts." The Proposal defines "mark-to-market coverage amount" as the amount payable by a fund if the fund were to exit a derivatives position at the time the determination is being made

[8] "Covered call" would be defined in the same manner described in Section II, above.

and "risk-based coverage amount" as the amount that represents, at the time of determination, a "reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions, determined in accordance with policies and procedures (which must take into account, as relevant, the structure, terms and characteristics of the derivatives transaction and the underlying reference asset) approved by the fund's board of directors[.]"[9] The Proposal permits both the mark-to-market coverage amount and the risk-based coverage amount to be calculated on a net basis where there are multiple derivatives transactions entered into by the fund under a "netting agreement that allows the fund to net its payment obligations with respect to multiple derivatives transactions[.]" The Proposal also permits a fund to reduce its mark-to-market coverage amount by the value of assets representing variation margin or collateral and to reduce its risk-based coverage amount by the value of assets that represent initial margin or collateral.

In order to trade listed options, a fund must open an account with a broker-dealer (1) that is a member of OCC and the relevant options exchanges or, (2) that has a clearing arrangement with such a member firm. Any such broker-dealer must also be a member of the Financial Industry Regulatory Authority, Inc. ("FINRA"). All broker-dealers are subject to detailed, long-standing margin requirements promulgated by the Federal Reserve (Regulation T), FINRA and the options exchanges. In addition, OCC's members are subject to OCC's margin requirements. The SROs are required to file proposed changes to their margin rules with the Commission, which helps ensure consistency in margin requirements among the SROs.

The Proposal makes no mention of the fact that there is a well-established regulatory regime pursuant to which broker-dealers are required to collect margin from customers, including funds. We believe this aspect of the Proposal should be carefully coordinated with subject matter experts within the Commission, including staff in the Division of Trading and Markets from the Offices of Clearance and Settlement and Financial Responsibility, with FINRA and with the options exchanges. We believe it would be disruptive and create unnecessary complexity for a fund to be required to comply with Proposed Rule 18f-4(a)(2) with respect to listed derivatives such as listed options. We believe there should either be an express carve-out from that rule for listed derivatives (including listed options), or that a fund should be deemed to be in compliance with the requirement to maintain in segregation assets sufficient to cover its mark-to-market coverage amount and risk-based coverage amount with respect to transactions in listed derivatives, including listed options, provided that the fund is in compliance with such margin requirements as are imposed by its brokers pursuant to applicable regulations.

b. <u>The Definition of "Exposure" Should Be Revised to Expand Upon the Allowed Offsets</u>

The Proposal defines "Exposure" to mean, with respect to derivatives transactions, "[t]he aggregate notional amounts of the fund's derivatives transactions, provided that a fund may net any directly offsetting derivatives transactions that are the same type of

[9] Proposed rules 18f-4(c)(6) and (9).

instrument and have the same underlying reference asset, maturity and other material terms[.]"[10] We believe, for example, that the netting permitted under this definition is not sufficient to recognize the risk-reducing impact of holding multiple positions in listed options on the same underlying security in the same fund account. We believe broader netting of exposures should be allowed with respect to listed derivatives, including listed options, in a manner consistent with other applicable regulations.

In the Proposal, the Commission indicates that the proposed netting language in the "exposure" definition "would . . . apply to situations in which a fund seeks to reduce or eliminate its economic exposure under a derivatives transaction without terminating the transaction." The Commission addresses certain specific transaction pairs, including a "written option that has a different maturity date or a different underlying reference asset." The Commission expressed its concern that this "could raise potential risks associated with strategies that seek to capture small changes in the value of such paired investments[,]" such as options used in paired collar or spread strategies. The Commission indicated its belief that "it would be difficult to develop standards for determining circumstances under which such transactions should be considered to have eliminated the market and leverage risks associated with the positions in a manner that would appropriately limit the potential for funds to incur excessive leverage or unduly speculative exposures."

We agree that it may be difficult to develop standards for determining when one derivatives transaction has eliminated the market and leverage risks with respect to another derivatives transaction where at least one leg of the paired trade is an over-the-counter derivative. However, we do not see this difficulty where both legs are listed derivatives such as listed options. In this regard, for instance, the listed options market already has in place a well-established regulatory regime under which the regulators and SROs have determined which offsets between listed options truly act to offset risk and the extent to which they do so. Those rules are the margin regulations applicable to the broker through which funds enter into listed options transactions. The Proposal could be revised to take account of regulations such as these in several ways, but we believe the proper way would be to alter the definition of "Exposure" under the Proposal and add a definition of "Listed derivative," each as follows:[11]

> *Exposure* means the sum of the following amounts, determined immediately after the fund enters into any senior securities transaction:
>
> (i) The aggregate notional amounts of the fund's derivatives transactions **that are not listed derivatives**, provided that a fund may net any directly offsetting derivatives transactions that are the same type of instrument and have the same underlying reference asset, maturity and other material terms;
>
> **(ii) The aggregate notional amounts of the fund's listed derivatives, provided that a fund may net any directly offsetting listed derivative to**

[10] Proposed rule 18f-4(c)(3).

[11] The following markup does not include other revisions we are proposing above to these provisions.

the same extent that margin offsets are permitted under applicable margin rules;

~~(ii)~~**(iii)** The aggregate financial commitment obligations of the fund; and

~~(iii)~~**(iv)** The aggregate indebtedness (and with respect to any closed-end fund or business development company, involuntary liquidation preference) with respect to any senior securities transaction entered into by the fund pursuant to section 18 (15 U.S.C. 80a– 18) or 61 (15 U.S.C. 80a–61) of the Investment Company Act without regard to the exemption provided by this section.

Listed derivative **means a derivative transaction that is executed on an exchange and submitted to and accepted for clearing by a central clearing counterparty.**

We also note the following statement in the Proposal: "Similarly, a purchased option would not offset a written option that has a different maturity date or a different underlying reference asset." While we agree with this statement, we would also like to point out that because the Commission has indicated that a purchased option is not a "derivatives transaction," as a technical matter a purchased option would not offset a written option even if it did have the same maturity date, underlying reference asset, maturity and other terms. We do not think it was the intention of the Commission in drafting the Proposal to imply otherwise.

IV. The Definition of "Notional Amount" Should More Clearly Reference Delta-Adjusted Notional Amounts for Options

The Proposal would allow the Notional Amount of an option to be adjusted by the option's delta.[12] This is necessary to "have an accurate measurement of the exposure that an option creates to the underlying reference asset."[13] We agree with this statement, however, we believe that in order to improve the clarity of the rule and as a convenience to practitioners the adjustment of notional amount for options delta should be included in the text of the final rules themselves, and not relegated to the descriptive text accompanying the Proposal. This could be accomplished by adding a new sub-part to the definition of "Notional amount," as follows:

Notional amount means, with respect to any derivatives transaction:

(i) * * *

(ii) * * *

(iii) Notwithstanding paragraphs (c)(7)(i) and (ii) of this section:

[12] Proposal at 80902-03.

[13] *Id.* at n. 163.

(A) * * *

(B) For any derivatives transaction for which the reference asset is a managed account or entity formed or operated primarily for the purpose of investing in or trading derivatives transactions, or an index that reflects the performance of such a managed account or entity, the notional amount shall be determined by reference to the fund's pro rata share of the notional amounts of the derivatives transactions of such account or entity; ~~and~~

(C) For any complex derivatives transaction, the notional amount shall be an amount equal to the aggregate notional amount of derivatives instruments, excluding other complex derivatives transactions, reasonably estimated to offset substantially all of the market risk of the complex derivatives transaction**;** ~~.~~ **and**

(D) For any option, the notional amount shall be adjusted by the delta of the option.

V. The Definition of "Qualifying Coverage Assets" Should Be Modified to Include Other Assets That Are Permissible as Margin Under Applicable Rules

We believe the definition of "qualifying coverage assets" under the Proposal is too narrow with respect to listed derivatives such as listed options. For example, the rules of the exchanges and FINRA permit certain assets other than cash or cash equivalents to be posted as margin in connection with listed options, and we see no reason why the Proposal would impose more stringent requirements on funds than those to which they are already subject when trading listed derivatives such as listed options. We propose that the Commission alter the definition of "qualifying coverage assets" and add a definition of "Listed derivative," each as follows:

Qualifying coverage assets means assets of the fund described in paragraphs (c)(8)(i) through ~~(iii)~~**(iv)** of this section, provided that the total amount of a fund's qualifying coverage assets shall not exceed the fund's net assets, and that assets of the fund maintained as qualifying coverage assets shall not be used to cover both a derivatives transaction and a financial commitment transaction:

(i) Cash and cash equivalents;

(ii) With respect to any listed derivative, any asset, including an escrow receipt, that may be used as collateral in a margin account or posted as initial margin under applicable margin rules;

~~(ii)~~**(iii)** With respect to any derivatives transaction or financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; and

~~(iii)~~**(iv)** With respect to any financial commitment obligation, assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors as provided in paragraph (b)(2) of this section.

Listed derivative **means any derivatives transaction that is executed on an exchange and submitted to and accepted for clearing by a central clearing counterparty.**

VI. Conclusion

We appreciate the opportunity to provide the foregoing comments on the Proposal. We would be happy to assist the Commission in any way possible as the Commission works toward completion of a final rule. If you have any questions, please do not hesitate to contact me.

Sincerely,

Craig S. Donohue
Executive Chairman
The Options Clearing Corporation

Cc: Mary Jo White, Chair
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner