1765 Greensboro Station Place, Suite 900, McLean, VA 22102

March 24, 2020

<u>Via Electronic Submission</u>

Vanessa Countryman
Secretary

Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Comment on File Number S7-24-15

Dear Ms. Countryman:

Cboe Vest Financial LLC ("Cboe Vest") is pleased to submit this letter in support of the proposed new rule by the Commission, designed to enhance the regulation of the use of derivatives by registered investment companies. We concur with and applaud the Commission's assessment that derivatives have become increasingly more important in effective portfolio management, and that standardizing the framework for fund derivative risk management will benefit investors, funds and markets. Cboe Vest believes the proposed new rule—a re-proposal of Rule 18f-4—provides more effective risk management, greater transparency and enhanced investor protection. Therefore, we support the Commission's efforts to adopt the rule. At the same time, as explained below, it is our recommendation that purchased options spreads and covered calls be excluded from the definition of "derivatives transaction" under the proposal.

Background

Since its inception in 2012, Cboe Vest has pioneered unique derivative-based strategies and investment products known as Target Outcome Investments. Target Outcome Investments are typically registered investment companies that primarily hold options that trade on an exchange ("Listed Options"). Listed Options provide investment companies with risk management tools, affording them the ability to hedge downside risk through the purchase of put options, the ability to engage in risk-limited transactions to gain exposure through the purchase of call options, and the ability to generate an income stream from the sale of call options against a holding of underlying securities.

Our product management and portfolio management teams—renowned experts in derivatives—are responsible for designing, building and trading Cboe Vest's derivative-based Target Outcome Investments, which seek to deliver the benefits of Listed Options to investors in registered investment companies. Cboe Vest serves as an advisor, sub-advisor or portfolio consultant to various investment companies, including mutual funds, exchange-traded funds ("ETFs") and unit investment trusts ("UITs"), and manages or supervises more than $1 billion in assets (as of March 10, 2020) in Listed Options-based strategies. At our core, we know that derivatives are useful tools that deliver unique benefits to investors when used responsibly and with well-defined guidelines.

Changing the Definition of "Derivatives Transaction" to Exclude Purchased Options Spreads and Covered Calls

The proposed new rule defines the term "derivative transaction" as a derivative instrument that must involve a future payment obligation. This definition recognizes that "a purchased option that makes a nonrefundable premium payment to obtain the right to acquire (or sell) securities under the option" would not involve a future payment obligation and thus would not be a derivative transaction. The Commission appropriately recognizes that the investment company buying a call or put option must pay an upfront amount (known as the "premium") for each option contract, and that the purchase of a call or put option by an investment company only exposes the investment company to the loss of the premium, and not a future payment obligation. While Cboe Vest agrees that purchased options should be excluded from the final rule, we are concerned that the proposed rule's narrow definition of a purchased option would unduly limit the ability of investment companies to effectively use purchased-options-spread strategies or covered-call strategies.

<u>Purchased options spread</u>
The Commission should note that Listed Options provide investment companies with the ability to engage in risk-limited transactions through strategies such as purchased-options-spread trades. Purchased options spreads are the basic building blocks of many options-trading strategies. A purchased-options-spread position is entered by buying and selling an equal number of options of the same class (i.e., options on the same underlying security), same options style (i.e., either only exercisable at expiration or exercisable at times prior to expiry), and same expiration date, but with different strike prices. In comparison to purchased-options strategies, purchased-options-spread strategies are used by investment companies as a technique to reduce the upfront premium that the investment company pays to obtain the right under the option, while limiting the right of the options over a certain range of prices of the underlying security.

For example, consider a fund that hedges against losses by purchasing a put option on the S&P 500 Index with an expiry date of approximately one month. A put at a strike price that equals the level of the S&P 500 Index at the time of the purchase seeks to hedge against losses in the S&P 500 Index from that level. However, the premium the fund will have to pay for the purchase of the put option could be quite large—particularly during times of higher volatility—and could expose the fund to substantial loss of the premium if the level of the S&P 500 Index increases over the subsequent month. To limit losses from the upfront premium paid, the fund may instead purchase a put spread, which involves purchasing a put option on the S&P 500 Index at a strike price that equals the current level of the S&P 500 Index, while at the same time selling a put option on the S&P 500 Index at a strike price that equals 90% of the current level of the S&P 500 Index. The expiry date of the sold put option would be the same as the expiry date of the purchased put option. The net premium paid by the fund from the buying and selling of the put options will be lower than the premium paid from only purchasing the put option. In addition, the put-spread strategy will allow the fund to limit the upfront cost of its hedge while providing protection against the first 10% drop in levels of the S&P 500 Index.

From the perspective of the proposed rule, the sold put option by itself will create a future payment obligation. However, when combined with the purchased put option as a purchased options spread, the future payment obligation created by the sold put option will never exceed the payment potential of the purchased put option. In other words, when options that expire at the same time are purchased and sold on the same underlying security, but with different strikes and culminating in a net upfront premium payment, there is not a fund payment obligation created by the options spread.

We do not believe that purchased options spreads create the same concerns about excessive leverage or risk that are posed by other transactions in derivatives. Although sold options, when viewed in isolation, do expose the fund to a potential future obligation, that obligation will be entirely offset by purchased options when:

- The strike price of purchased call options is equal to or lower than the strike price of the sold call options, or when the strike price of the purchased put options is equal to or higher than the strike price of the sold put options;
- All options that are part of the options spread are equal in number of options;
- All options are of the same class (i.e., options on the same underlying security); and
- All options have the same options style (i.e., either only exercisable at expiration or exercisable at times prior to expiry).

Covered calls

The Commission should note that Listed Options are used by investment companies to engage in covered-call selling. Covered-call selling involves selling call options against positions in the underlying security to generate premium income—a unique source of return for investors. A sold call option, taken by itself, has limited profit potential in the form of the premium collected, but the option assumes unlimited risk. The seller theoretically stands to lose an unlimited amount if the price of the underlying security goes up substantially higher than the strike price of the sold call. The seller of the call option may eliminate this unlimited risk by holding the underlying security. In a scenario in which an investment company holds at least the number of units of the underlying security to fully cover the sale of the call, the strategy is considered a covered-call-selling strategy.

From the perspective of the proposed rule, the sold call option by itself will create a future payment obligation. However, when combined with the position in the underlying security, the future payment obligation created by the sold call option will never exceed the value of the underlying security. We do not believe that a covered-call strategy creates the same concerns about excessive leverage or risk that are posed by other transactions in derivatives. Although sold call options in isolation do expose the fund to a potential future obligation, that obligation will be entirely offset by the position in the underlying security.

Accordingly, it is our recommendation that purchased options spreads and 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 to explicitly **exclude derivative instruments that, when combined with other derivative instruments or securities held by an investment company, do not together create a net future obligation under which the investment company is or may be required to make any payment or delivery of cash or other assets, other than those that are part of the foregoing combined trade, during the life of the instrument or at maturity or early termination, whether as margin, settlement payment or otherwise.** Such a treatment will place purchased options spreads and covered calls in harmony with options margin rules for brokerage accounts. These margin rules, which have been reviewed by the Commission, recognize the risk-reducing nature of purchased options spreads and covered calls and create positive equity for the accounts in which they are purchased.

Cboe Vest greatly appreciates the Commission's thorough exploration of the issues and benefits related to derivatives, and the opportunity to comment on the comprehensive risk management framework in the proposed rule. Please contact me if I can answer any questions or be of service.

Sincerely,

Karan Sood
CEO