OCC THE FOUNDATION FOR SECURE MARKETS

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VIA ELECTRONIC MAIL

Ms. Vanessa Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

RE: File No. S7-24-15, Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles

Dear Ms. Countryman:

The Options Clearing Corporation ("OCC") appreciates the opportunity to submit these comments on re-proposed Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "Investment Company Act") and supports the efforts of the Securities and Exchange Commission (the "SEC" or "Commission") to provide an updated and more comprehensive approach to regulating the use of derivatives and other transactions addressed in the Proposed Rule by mutual funds (other than money market funds), exchange-traded funds ("ETFs"), registered closed-end funds, and companies that have elected to be treated as business development companies under the Investment Company Act (collectively, "funds").[1] The Proposed Rule would characterize derivative transactions, reverse repurchase transactions and transactions similar to those as "senior securities" within the meaning of Section 18 of the Investment Company Act but permit funds to enter into those transactions, notwithstanding the restrictions under the Investment Company Act, provided that the funds comply with the conditions of the rule. Those conditions include compliance with one of two value-at-risk ("VaR") tests, adoption of a derivatives risk management program that is overseen by a derivatives risk manager and by a fund's board of directors, and enhanced reporting requirements.

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[1] The SEC is also proposing new sales practice rules regarding the offer and sale of leveraged/inverse investment vehicles as part of the proposal, though OCC's comments are limited to the Proposed Rule. See Release No. 34-87607; IA-5413; IC-33704 (Nov. 25, 2019), 85 FR 4446 (Jan. 24, 2020). The SEC proposed a prior version of Rule 18f-4 in 2015. See Release No. IC-31933 (Dec. 11, 2015), 80 FR 80883 (Dec. 28, 2015) ("2015 Proposal").

OCC fully supports the investor protection purposes of the Proposed Rule and believes the Commission has made effective modifications in its re-proposal of Rule 18f-4. The focus of our comments is to verify that certain aspects of the Proposed Rule will not unduly limit or otherwise inhibit the ability of funds to effectively use options listed and traded on national securities exchanges ("listed options").

I. About OCC and the Listed Options Market

OCC is the world's largest equity derivatives clearing organization. OCC clears listed options as the sole clearing agency for all national securities exchanges trading such products ("Options Exchanges"), in addition to clearing other products. OCC operates under the jurisdiction of both the Commission and the Commodity Futures Trading Commission. In July 2012, the Financial Stability Oversight Council designated OCC as a systemically important financial market utility ("SIFMU") under Title VIII of the Dodd-Frank Act. As a SIFMU, OCC also is subject to oversight by the Board of Governors of the Federal Reserve System.

Listed options have been traded on the Options Exchanges since 1973. The Options Exchanges currently offer options on approximately 4,500 different stocks and other equity products such as ETFs, as well as indices based on equities, volatility and other products. In 2019, some 4.42 billion equity options were traded on the Options Exchanges, with each contract typically covering 100 shares of its underlying security. When listed options on securities indices are included, some 4.9 billion listed options were traded on the Options Exchanges in 2019, or an average of approximately 19.4 million contracts every trading day.

Funds are becoming increasingly important participants in the listed options market, as listed options provide a valuable risk management tool that allows them to efficiently and cost-effectively adjust an investment's risk/return characteristics. For instance, funds can use listed options to hedge their exposures to individual equity positions. Funds can use them to generate income by engaging in a low-risk strategy known as writing "covered calls."[2] In addition, funds can use listed options to engage in risk-limited transactions to gain exposure to individual stocks or indices through strategies such as spread trades.[3] Funds also can use listed options to manage the risks associated with their entire securities portfolios. OCC wants to ensure that funds can continue to effectively use listed options in these ways consistent with the Proposed Rule.

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[2] A call option is considered "covered" if the writer of the option owns the shares underlying the option. 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.

[3] Option 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.

II. The Proposed Rule Appropriately Excludes Purchased Options from VaR Limits and Should Clarify that Purchased Options and Off-Sets are Excluded from Calculation of the Limited Derivatives User Test

The Commission has appropriately recognized that purchased options do not create leverage of the type the Proposed Rule is intended to address.[4] The Proposed Rule imposes the VaR tests and many of the other compliance obligations only on "derivatives transactions" which it defines as one of several specified types of derivatives instruments, including options "under which a 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 margin or settlement payment or otherwise" as well as any short sale borrowing. The Commission notes that the first prong of the definition requires that "a derivatives instrument…must involve a future payment obligation," and that "[t]his aspect of the definition recognizes that not every derivatives instrument imposes an obligation that may require the fund to make a future payment, and therefore not every derivatives instrument will involve the issuance of a senior security" subject to the limitations under the Investment Company Act.[5] The Commission further notes that "[a] derivative that does not impose any future payment obligation on a fund generally resembles a securities investment that is not a senior security, in that it may lose value but will not require the fund to make any payments in the future."[6]

While purchased listed call and put options are derivative instruments, they only expose a fund to the loss of the premium (*i.e.*, the purchase price for the option), and do not create a future payment obligation. As they do not expose a fund to a future payment obligation, they would not fall within a "derivatives transaction" under the Proposed Rule.

In contrast, purchased options appear to be *included* in the proposed definition of "derivatives exposure" under the Proposed Rule.[7] As a result, funds holding purchased options would be required to include the value of purchased options in their calculation of exposure to determine whether they qualify as a "limited derivatives user." [8] If the definition of "derivatives exposure"

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[4] The 2015 Proposal also excluded purchased listed options.

[5] 85 FR at 4456.

[6] Id.

[7] The definition of "derivatives exposure" (which is used to determine whether a fund is a limited derivatives user and excluded from most of the Proposed Rule's requirements) is defined as the sum of the notional amounts of the fund's *derivatives instruments* rather than derivatives transactions. The term "derivatives instrument" is embedded in the definition of "derivatives transaction." We understand the Proposed Rule to define a derivatives instrument to mean "any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument." As a result, we view a "derivatives instrument" to include either purchased or written options.

[8] To qualify as a limited derivatives user, either a fund's derivatives exposure may not exceed 10 percent of the fund's net assets or the fund would limit its use of derivatives transactions to certain currency derivatives used to hedge portfolio holdings.

includes purchased options, a fund that holds long options valued at greater than 10% of the fund's net assets would be required to comply with the VaR-based limits and adopt a risk management program even though the fund did not take on any leverage. We believe this would be inconsistent with the purpose of the Proposed Rule and request that the Commission clarify that "derivatives exposure" would *not include* purchased options. Without this clarification, we are concerned that the Proposed Rule could discourage funds that rely on the limited derivatives user exemption from purchasing listed options.[9]

Finally, we think it would useful for the Commission to note, as guidance in the adopting release, that entry by a fund into an equal and off-setting listed options position would extinguish the existing option's exposure so that neither off-setting position should be included in a fund's calculation of derivatives exposure. In fact, where funds solely enter into equal and off-setting listed options positions, we believe the Commission should consider excluding such activity from the scope of the Proposed Rule.

III. The Proposed Rule Appropriately Eliminates the Asset Segregation Requirement in Favor of a VaR Test

The 2015 Proposal included a requirement that a fund with derivatives exposures was required to segregate assets to cover those exposures. In particular, under the 2015 Proposal, a fund would not have to segregate a derivative's full notional amount, but instead could segregate qualifying coverage assets (generally cash and cash equivalents) equal to the sum of two amounts: (1) the amount that would be payable by the fund if the fund were to exit the derivatives transaction at the time of determination (the "mark-to-market coverage amount"), and (2) a reasonable estimate of the potential amount payable by the fund if the fund were to exit the derivatives transaction under stressed conditions (the "risk-based coverage amount").

The Proposed Rule has eliminated this asset segregation requirement and now would require funds, other than limited derivatives users and leveraged/inverse funds ("excluded funds"), to comply with a VaR test. Under the proposed VaR test, funds (other than excluded funds) entering into derivatives transactions would be required to ensure each business day that the VaR of the fund's portfolio does not exceed 150% of the VaR of a designated reference index. If a fund's risk manager is unable to identify an appropriate designated reference index, the fund would be required to comply with an absolute VaR test, under which the VaR of the fund's full portfolio would not be allowed to exceed 15% of the value of the fund's net assets.

OCC supports the Commission's proposed elimination of this asset segregation requirement. As reflected in industry comments on the 2015 Proposal, the requirement would have been difficult to administer and did not properly account for the risk associated with certain derivatives such as listed

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[9] We note that the definition of "derivatives exposure" is also referenced in the proposed amendments to Form N-PORT. For reporting purposes, we do not believe that it would be inappropriate for a fund to reflect both purchased and written options positions.

options. In this regard, many of our prior comments on the 2015 Proposal related to the treatment of listed options under the asset segregation requirement.[10]

For instance, OCC was concerned about the treatment of covered calls under the 2015 Proposal. Writing covered calls is a popular listed options strategy used to generate income in the form of options premiums. To execute a covered call, a fund holding equity shares writes call options on those shares. The fund's long position in the shares allows the fund to "cover" its exposure to the written call option because the fund can deliver the shares to the buyer of the call option if the buyer chooses to exercise it. Because the fund's written call options are covered by the underlying shares, OCC argued that covered calls should not be defined as derivative transactions covered by the 2015 Proposal, or in the alternative, that they should not be treated as creating derivative exposure for a fund for purposes of the asset segregation requirement. OCC also noted in its comments other issues regarding the treatment of listed options under the asset segregation requirement, including concerns about the treatment of margin assets posted by a fund under Commission and self-regulatory organization margin requirements for purposes of determining the fund's derivatives exposure under the asset segregation requirement. By eliminating the asset segregation requirement, OCC notes that the Proposed Rule would address these concerns as they relate to risk exposure calculations.

OCC further supports the Commission's approach of using a VaR test instead to address the concerns and limitations under the Investment Company Act regarding funds' use of derivatives. OCC notes, for instance, that a fund writing covered calls would not increase its exposure under a VaR test. In fact, a fund writing covered calls would reduce its exposure under a VaR test because the call premium would reduce the cost basis of the underlying equity security by the amount of the premium. OCC believes this is the right outcome from a risk management perspective.

We note, as the Commission did in the Proposed Rule, that VaR is a widely used risk management measure within the financial services industry. As the central counterparty for the listed options market, OCC uses a VaR-based methodology known as STANS to determine its clearing member margin requirements. Based on the industry's positive experience with STANS and the robustness with which its supports the listed options market, OCC supports the use of a VaR test in the Proposed Rule. OCC, however, defers to fund managers and others within the fund industry as to whether 150% for the relative VaR test and 15% for the absolute VaR test are appropriate for the fund industry.

IV. The Proposed Rule Properly Allows for Delta-Adjustment of Options Exposure for Purposes of the Limited Derivatives User Exception

The Proposed Rule excludes from most of its requirements a fund that is a limited derivatives user, which would cover a fund with "derivatives exposure" that does not exceed 10 percent of the fund's net assets. For purposes of determining derivatives exposure under this exception, a fund is allowed

[10] See letter from Craig S. Donohue, Executive Chairman, OCC (Mar. 25, 2016), available at https://www.sec.gov/comments/s7-24-15/s72415-84.pdf.

to delta-adjust the notional amount of an options contract. The Commission notes in the proposing release that, "permitting delta adjusting of options is designed to provide for a more tailored notional amount that better reflects the exposure that an option creates to the underlying reference asset."[11] OCC agrees with this statement, as allowing a fund to delta-adjust the notional amount of a listed options contract allows the fund to get a more accurate picture of its exposure to the underlying security or index. Accordingly, OCC supports the Commission's use of delta-adjustment in the context of determining whether a fund qualifies for the limited derivatives user exception.

V. Conclusion

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

Sincerely,

Craig S. Donohue

Craig S. Donohue
Executive Chairman

[11] 85 FR at 4484.