



Via Electronic Submission

March 24, 2016

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Notice of Proposed Rulemaking on Use of Derivatives by Registered Investment Companies and Business Development Companies, RIN 3235-AL60

Dear Mr. Fields:

OneChicago, LLC (“OneChicago,” “OCX,” or the “Exchange”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) proposal relating to the use of derivatives by registered investment companies (“RICs”). By way of background, OneChicago is a security futures exchange registered with the Commodity Futures Trading Commission (“CFTC”) as a designated contract market and notice-registered with the SEC as a national securities exchange for the limited purpose of trading security futures products (“SFPs”).¹

Security futures are contracts for the sale or future delivery of a single security (“SSFs”) or of a narrow-based security index (“NBIs”).² Currently, OneChicago lists SSFs overlaying approximately 1,500 equity securities.³ Although SSFs may be used for hedging or speculative purposes, the primary use of SSFs is equity finance; that is, as a tool to lend/borrow securities (securities lending) or to lend/borrow cash using securities as collateral. As futures products, OneChicago’s SSFs clearly fall within the SEC’s definition of “derivative” in the proposed rule, thereby subjecting the use of SSFs by RICs to the proposed exposure limitations.

In general, OneChicago agrees with the proposed exposure limitations for SSFs if these products are used in a speculative manner. However, we believe that when SSFs are used to effectuate securities lending or general equity finance transactions, the Commission should treat these transactions in the same way as their economic equivalents are treated, and should not be treated

¹ An SFP is a security future or any put, call, straddle, option, or privilege on any security future.

² 7 USC § 1a(44).

³ OneChicago does not currently list any NBIs.

the same way as a directional risk position would be simply because SSFs are considered derivatives. Such a rudimentary grouping of these products into one derivatives “bucket” would ignore the economic substance of these transactions, and would diminish the opportunities of RICs to use these products for equity finance purposes. Accordingly, please find below a description of the ways SSFs can be used to effectuate these transactions. We hope that by explaining the uses of these products, the Commission can see why it would be more appropriate to group the resultant transactions with their economic equivalents, rather than to simply group all derivative products together.

Securities Lending Using SSFs

In the securities lending market, securities can be classified as either hard-to-borrow or general collateral. A security is hard-to-borrow if there is short pressure on the security, and consequently, a higher than normal fee for borrowing the security due to the large demand to borrow and sell the security short. A security is general collateral if there is no such hard-to-borrow pressure. A RIC holding hard-to-borrow securities may choose to loan those securities out in order to earn additional income on the otherwise idle assets.

Historically, this process typically occurs through bilateral, over-the-counter (“OTC”) securities lending agreements.⁴ However, they may also occur by using SSFs on regulated exchanges like OneChicago. A RIC holding hard-to-borrow securities can lend the securities out by buying a futures calendar spread,⁵ which involves selling an expiring future and purchasing a far-dated future, both overlaying the security the RIC wants to loan out. The expiring future obligates the RIC to transfer the underlying security to the borrower in one day, and the far-dated future will require the transfer of the security back to the RIC upon expiry of the loan. The RIC buys the spread at a discount, which represents the “loan fee” that the RIC earns for lending out the hard-to-borrow security.⁶

The borrower is usually a party that is currently paying a premium to borrow the securities in the securities lending market, but wishes to reestablish its short position in an SSF instead. The borrower would take the other side of the SSF spread (*i.e.*, “sells the spread”) by purchasing the expiring future and selling the far-dated future. The expiring future will settle and the underlying security will be delivered to the borrower in one day, with which the borrower will close its short borrow position in the borrowed security. The short position has then been established in the borrower’s short, far-dated SSF position. The borrower’s short position in the far-dated SSF will

⁴ The standard transfer agreement in an OTC securities lending transaction is the Global Master Securities Lending Agreement (“GMSLA”). This agreement is a derivative that provides the securities lender with economic exposure to the loaned security and requires return of the loaned security upon termination of the loan. OneChicago’s SSF products perform the exact same function as the GMSLA when used for securities lending.

⁵ See OCX Rule 418.

⁶ In the SSF market, the far-dated future is generally priced higher than the near-dated future due to the interest rate component of SSF pricing. However, for hard-to-borrow securities, the SSF overlaying the security trades in backwardation where the hard-to-borrow pressure pulls the price of the far-dated future down to, or below, the price of the near-dated future. Therefore, it is possible that in a warm-to-borrow security (*i.e.*, mildly hard-to-borrow security), the near-dated and far-dated futures are priced equally, or, depending on the level of the prevailing interest rate, the near-dated future is still priced below the far-dated futures, even though there is *some* hard-to-borrow pressure in the security.

require the borrower to return the borrowed securities upon the expiry of the future. The difference in the two prices (of the expiring future and far-dated future) is the “loan fee” that the borrower pays the lender for the right to borrow the security. Unlike other derivatives positions in which the risk profile of the position changes throughout its life, an SSF spread trade is riskless in that the profit and loss is known and locked in at the time of the transaction. The position simply unwinds upon expiry of the far-dated future leg, and the securities lender captures the difference between the two futures leg prices as a securities lending fee.

Under the SEC’s proposed rules, securities lending transactions are not treated as derivatives or financial commitment transactions. Rather, securities lending transactions are currently subject to SEC staff’s view that “a mutual fund should not have on loan at any given time securities representing more than one-third of its total asset value.”⁷ OneChicago makes no comment on whether this is an appropriate limit for mutual fund securities on loan, or whether securities lending should be treated as a derivative or financial commitment transaction. We simply believe that a RIC’s use of transactions that are economically equivalent to securities lending should be treated in the same way the Commission determines to treat securities lending. This approach would ensure that the Commission looks through the mere form of a transaction to its economic substance. It would be an unusual result if RICs were subject to one set of limits when lending their securities using an OTC, bilateral agreement such as the GMSLA, and simultaneously subject to an entirely different, more restrictive set of limits when lending securities using SSFs. This is especially true in light of the fact that SSFs are centrally cleared and highly regulated, whereas bilateral, OTC securities lending transactions are neither. Simply having the word “future” in a product’s name should not be the determining factor in establishing the treatment of combination transactions such as SSF spread transactions.

Lending or Borrowing Cash

In the securities lending transaction described above, the securities themselves warrant the premium as they are the desirable asset in the transaction. RICs may choose to conduct the identical transaction with general collateral rather than hard-to-borrow securities in order to loan or borrow cash, rather than to loan or borrow the securities themselves. When a RIC transfers (or takes) general collateral securities with an SSF spread, it is not loaning the securities as in the example above because the securities do not warrant a premium. Rather, the RIC can borrow or lend cash using the general collateral securities as collateral for the loan. A RIC with cash reserves may choose to lock in a rate of return on the cash by executing a SSF calendar spread transaction. For example, a RIC lender of cash can simply sell a futures calendar spread, which would involve the purchase of the near-dated future, and the sale of the far-dated future. The purchase of the near-dated future requires the lender of cash to take delivery of the underlying security (providing the counterparty with the cash in the process), and the sale of the further-dated future will require the RIC lender of cash to return the security upon termination of the loan (and receive back its loaned cash principal). The lender of cash sells the far-dated future at a higher price than that at which it purchases the near-dated future, and the difference is the “loan fee” for the cash.

⁷ See, e.g., The Brinson Funds, SEC Staff No-Action Letter (Nov. 25, 1997), available at <https://www.sec.gov/divisions/investment/noaction/1997/brinsonfunds112597.pdf>.

As was the case in the securities lending example above, the Commission should regulate RIC's use of SSFs to carry out these financing transactions in the same way the Commission would regulate equivalent financing transactions in the OTC market. SSFs should not fall under the derivatives regime when used as a combination transaction to effectuate a loan or borrow of cash, while bilateral transactions remain excluded. Both of these transactions represent the same risk profile, and should therefore be treated similarly for purposes of the proposed rule.

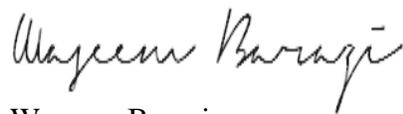
Conclusion

OneChicago agrees with the Commission's proposal to limit the use of derivatives by RICs. However, we believe it is critical for the Commission to recognize that derivatives like OneChicago's SSFs, which are subject to the proposed limitations on use, can replicate transactions such as securities lending and other financing transactions, which are not subject to the proposed limitations on use. Therefore, the Commission should note in its final rule that economically identical transactions to any transactions that are excluded from the derivatives limits (such as securities lending), are also excluded, even if a component of the identical transaction is a derivative.

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OneChicago sincerely appreciates the opportunity to comment on the proposal, and would like to make itself available to provide any further input the Commission may request regarding the proposal. OneChicago looks forward to working with the Commission to address the issues described above. If you have any questions or comments regarding this submission, please feel free to contact me at any time by phone at [REDACTED] or through e-mail at [REDACTED].

Respectfully Submitted,



Waseem Barazi
Chief Regulatory Officer and Associate General Counsel