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E. Russell Ives, Jr.
President

July 2, 2015

VIA ELECTRONIC DELIVERY

Mr. Brent J. Fields
Secretary
Division of Trading and Markets
U. S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-75115; File No. SR-NYSEArca-2015-02)

Dear Mr. Fields:

Ives Associates, Inc. ("Ives") is pleased to have the opportunity to submit this letter in response to a request by the Securities and Exchange Commission ("Commission") for comment on Release No. 34-75115; File No. SR-NYSEArca-2015-02. The subject of the Release is the rule change proposed by NYSE Arca, Inc. ("Arca"), as amended, to adopt generic listing standards for Managed Fund Shares.

Ives is a privately held firm focused on developing new means for financial markets participants to adapt to the impact of regulatory reform—more specifically, for liquidity investors seeking alternatives to money funds and bank deposits and for dealer banks seeking capital efficiency and an alternative to repo for customer financing. In that context and pursuant to expressed written interest from the Board of Governors of the Federal Reserve System and discussion with the Commission, Ives believes that an investment company may be able to be formed to use OTC derivatives to link the liquidity needs of investors with the financing needs of banks and to create what effectively is a swap-based collateralized deposit alternative.

Ives supports the Arca proposal subject to conforming the threshold limits on OTC derivatives of Arca Commentary .01(e)(1) to the Commission's treatment of offsetting ("covered)" derivatives positions for purposes of compliance with Section 18(f) of the Investment Company Act concerning restrictions on fund leverage.

In the Arca proposal on pages 18 and 42, Arca acknowledges (i) the need for a fund to have its derivatives positions comply with Section 18(f) of the Act and (ii) the Commission approved practice for a fund to cover derivative obligations with offsetting positions to comply with Section 18(f).

By following and enabling established practice, Ives believes that Arca's proposal will enable the Commission to achieve its objectives to create public benefit by expanding investor choice for liquidity product while maintaining strong investor protections, as more fully described below. At the same time, the proposal can serve to increase market liquidity by enabling banks to provide derivatives-based customer financing to replace capacity for repo.

The adoption of generic listing standards for actively managed exchange traded funds will encourage competition and innovation to expand investor options by reducing costs and increasing efficiencies for launching new funds. At the same time, investor protections can be maintained through the rules that limit portfolio components to certain specific criteria as set forth in Arca Rule 8.600 Managed Fund Shares, as proposed.

The portfolio holdings standards contained therein must be met and maintained for the generic listing to apply. As a result, the standards become critical if they are to provide investors with choice and adequate protections.

<u>Focus of Ives Comment Letter:</u>

With respect to the specific questions posed for comment by the Commission, Ives will confine its comments to the use of OTC derivatives and the calculation of compliance with the two threshold limits related thereto.

Ives notes that, as one would expect, the Arca proposal addresses the customary use of derivatives when it speaks of investment in derivatives, i.e., to acquire leveraged investment exposures to increase market risk for the possibility of greater returns. In the proposal, investment in derivatives means the purchase of a long position in a reference asset "to gain exposure", in the wording of the proposal.

While the investment in (or purchase of) derivatives is commonplace in the market, derivatives are sold as well, but less frequently, generally to hedge existing investment positions or to take short positions.

However, to the best of Ives research, there is not and has never been an investment company formed to sell derivatives. This different and novel strategy for an investment company has never been used, but warrants recognition as well, especially in light of the possibility for adapting to reform, as described below.

As a result, Ives is requesting a clarification of what constitutes an "investment in derivatives" for purposes of the percentage limitations for the proportion of OTC derivatives allowed and the proportion not centrally cleared.

Importantly, this clarification should be applicable to both purchases and sales of derivatives and therefore, for purposes of this letter, a fund investment in derivatives will also include a derivative that pays out or transfers an investment exposure.

The language in NYSE Arca Equities Rules, Rule 8.600 Managed Fund Shares, after Section (d) Initial and Continued Listing, *Commentary .01(e) is as follows:*

> Over-the-Counter ("OTC") Derivatives. The portfolio may hold OTC derivatives, including forwards, options and swaps on commodities, currencies and financial instruments (e.g., stocks, fixed income, interest rates, and volatility) or a basket or index of any of the foregoing.
>
> > (1) No more than 60% of the assets in the portfolio may be invested in OTC derivatives, provided, however, that no more than 20% of the assets in the portfolio may be invested in OTC derivatives that are not centrally cleared.

Fund Investments in OTC Derivatives:

As stated above, when Arca discusses use of derivatives in its proposal, it means the ownership or the acquisition of an investment exposure. Arca uses the terminology—use of derivatives—to mean to gain exposure to individual equities and/or fixed income securities, or to indexes of equities and/or indexes of fixed income securities. Such exposures would need to comply with the numerical and other criteria set forth in the proposed Commentary, including .01(a) and .01(b) to Rule 8.600 respectively.

Similarly, investors would likely have the same perspective: an investment in derivatives means the purchase of an investment exposure to assets where the buyer of the derivatives position (the investor) owns the market risk and return of the reference assets for a total return swap, for example.

As further evidence of this understanding, Arca discusses use of derivatives as gaining exposures and warns against such use that would enhance leverage. Arca acknowledges this view at several points in its filing. Gaining investment exposures through leverage is far and away the customary use of derivatives. For that reason, it was the expected focus of the proposal.

Ives asks for a clarification of how Arca proposes to quantify the amount of the derivatives investment to be calculated for compliance with the standards, wherein investment may mean purchases ***or*** sales.

Two treatments would seem possible:

The first possibility is to use the amount of any margin required by a swap counterparty for the purchase of a derivative by the fund. Margin is typically adjusted daily and could be considered in the nature of an investment by the fund. As such, the amount of any margin could be the amount counted for the Arca proposed percentage limit calculation.

A second treatment for the case of a fund purchase of a derivative would be to use the fund exposure to the notional amount of the underlying swap reference asset. That notional exposure could be used for purposes of the proposed percentage limitation. This approach would not be unreasonable, especially if the fund intended to purchase the underlying to maintain its exposure.

For the sale of a derivative, the fund would likely be the recipient of margin from the counterparty purchasing the derivative from the fund. So the above treatment would not apply. Further, while a sale of a derivative is effectively different, being a short position, one possible view to be consistent is to use the notional amount.

If the fund's counterparty wanted to purchase the reference asset to maintain an exposure, a purchase could be accommodated by the fund through a market purchase and sale or the counterparty could purchase the reference asset in the market.

Alternatively, the fund could sell the reference asset to the counterparty if it owned the underlying in an offsetting position.

Offsetting Derivatives Positions:

As background, the Commission and staff authority acknowledge strategies that funds adopt to offset the market risk of purchased or sold derivative positions. For some years, these offset positions have warranted relief from leverage restrictions pursuant to Section 18(f) of the Investment Company Act.

For a purchased derivative position, a fund would need some form of offset to cover a long exposure. Similarly, a sold derivative would require a long position to cover a short exposure.

For example, in the frequently cited Dreyfus no action letter from the Commission dated June 22, 1987, the Commission acknowledges that "covering" a derivatives position with an offsetting cash position effectively eliminates the derivatives exposure and would provide relief from leveraging restrictions contained in Section 18(f) of the Act.

Ives Suggested Amendment to Arca Commentary .01(e):

Based on the precedent of relief for covered positions with respect to Section 18(f) compliance, the derivatives percentage limitations of the Arca proposal could be amended to exclude those derivatives positions which are covered or offset by cash positions or comparable strategies.

Stated otherwise, the threshold OTC derivative percentage tests could be amended to include only those derivative positions which have market risk exposure because they are not offset.

To the extent that fund derivatives positions are offsetting, a fund can eliminate the market risk associated with the derivative. Interestingly, if this portfolio tactic could be applied without limits and broadened into a fund investment strategy to hold only reference assets for sold total return swaps, for example, an asset manager could build whole portfolios and funds with no market risk for broad investor appeal. If banks were the only approved swap counterparties to such funds, the shares could effectively be collateralized deposit alternatives.

Currently, the only product to be able to achieve this no market risk profile is believed to be an investment in a repurchase agreement. Here, a fund buys securities from a counterparty who agrees to repurchase the securities and who would continue to own the securities investment exposure—in the interim, paying the fund a repo rate and providing margin, adjusted daily to protect the fund from the securities market value risk. In effect, a fund investor in repo is able to avoid market risk and to isolate its primary risk to overnight, collateralized counterparty credit risk. To sustain a loss, securities subject to the repurchase agreement would have to fall in value below its margin at the same time the counterparty would have to default in its repo obligation—a risk profile commonly referred to as a double default risk.

While considered a very safe (especially with Government collateral) and stable value liquidity option, liquidity investors face sharply declining repo availability as the primary repo providers are dealer banks. Dealers have reduced matched book repo financing for customers because of regulatory pressures and balance sheet constraints. Because of the appeal of repo to liquidity investors, especially money funds, and their need for product, the Fed has currently filled this gap through an expanded set of counterparties for its Reverse Repo Program. However, its program is not permanent and many have expressed concerns about an expanded Fed footprint in the money markets, with the risk of crowding out others in a crisis and of becoming the "borrower of first resort" for liquidity investors, including money funds.

Swap-Based Funding Platform for New Product Development:

With adoption of the proposal and the Suggested Amendment, asset managers would have increased flexibility and incentive to capitalize on a derivatives-based funding platform for new product development. The opportunity is a means to address the continued supply constraints in short product and the growing need for stable value options to prime money funds and bank deposits with a repo-like product. To be implemented in an investment company, this platform is designed to have "zero value at risk" at all times through a very limited investment strategy: to offer total return swaps to approved counterparties and to purchase offsetting (matching) cash positions in the swap reference assets. The precedent for the strategy and its potential to meet investor objectives for stable value arise from comparability to the well-established repo product.

A short (sold) swap with a matching cash position in the swap reference asset replicates the economic profile of repurchase agreements. With a swap-based strategy, a fund would own the underlying swap reference assets with swap margin from an approved counterparty which would own the reference asset exposure and pay the fund a swap rate—comparable to the "double default" protection of repo. The primary fund risk of this strategy would be overnight, collateralized counterparty credit risk, the same as repo and with some similarity to secured lending structures such as covered bonds.

The challenge for investors would be to understand how a portfolio of asset positions with purchased "credit protection" from matching swaps with approved counterparties (likely banks) can be used to create a no market risk portfolio which would result in a market based stable net asset value.

To implement this strategy, counterparties would need to be identified who would value swaps and execute in large scale. While most financial markets participants recognize their utility and flexibility, total return swaps have been underutilized and never reached their potential because there has never been a large scale, efficient source of supply—exactly what an investment company could be created to provide.

For example, banks, in order to comply with regulatory reform, need new options for managing their capital and balance sheets, including the need of an alternative to repo for providing customer liquidity. Swaps can meet this need by allowing banks to acquire swap capacity from an investment company to offer customers in place of repo. Intermediating with matched swaps serves to conform dealer regulatory capital requirements to the economic capital cost of customer financing. With a better match of capital to risk and with little to no need for balance sheet capacity for customer liquidity, traders can expand the use of financing incentives to increase trading activity and market liquidity. Eliminating a balance sheet position allows a bank to avoid the customary allocation of equity capital needed for every asset (including repo) and can therefore reduce regulatory capital costs by 75 bp, based on the 5% leverage ratio and a 15% capital cost. These benefits are the incentives that dealer banks need to transition to new ways of serving customers that are compatible with the capital requirements of financial reform.

Asset managers will benefit as well from a new platform for constant NAV fund product development based on securities positions whose market exposure is owned by approved counterparties.

Stability of a Fund With a Swap-Based Funding Strategy:

For asset managers, a unique feature of a swap-based fund is the effect of its portfolio on fund shareholders:

- Such a fund's structure and portfolio composition are designed to mitigate investors' propensity to withdraw cash in a stress environment, making dealer funding more stable than with other products such as money market funds and repo;

- The fund would use swaps to "purchase protection" from approved dealer banks that guarantee income and a stable value for assets (designed to eliminate the risk of price change and to facilitate a constant NAV for redemptions);

- Portfolio market and credit risk would be owned by dealers, with primary Fund risk isolated to overnight collateralized counterparty credit risk ("double default" protection—collateral with swap margin and swap backing); and

- "Run" risk should be reduced as swaps lessen the probability of losing investor confidence from concerns about portfolio value, removing the incentive to gain from early redemptions.

Platform Compatibility with Regulatory Guidance:

Because of the importance of coordination with other regulatory authorities, the following points are offered to address the compatibility of swap-based funding with regulatory guidance:

- A private letter to Ives from the Board of Governors of the Federal Reserve System expressing (i) interest in dealer use of swaps to replace repo for customer financing and (ii) possible implications for future policy development; this letter was prepared in response to correspondence to then Chairman Bernanke from Ives requesting encouragement for the GSEs and dealer banks to use swap-based funding from an investment company to support investor liquidity for GSE MBS and housing finance;

- The new Supplementary Leverage Ratio rule provides regulatory capital relief for protection purchased and sold (matching swaps), in contrast to repo—encouraging dealer swap intermediation and mitigating the risk of a binding SLR;

- Swap usage facilitates compliance with Fed objectives to reduce short term wholesale bank debt without compromising customer needs for leverage and liquidity—mitigating possible GSIB surcharges and competitive inequities;

- Swaps will help to restore market liquidity: trading desks are enabled to increase their capacity to offer financing incentives without a balance sheet constraint;

- Swaps increase capital efficiency—a common senior management objective—by conforming regulatory capital requirements for customer financing to the real economic capital needed for the business; improved ROE and other metrics;

- An investment company using Treasury collateral would be an option to capture a meaningful share of the anticipated large outflow of funds from prime money funds and bank deposits which dealers could use to meet liquidity needs of customers for expanded trading;

- Other impact:

    - Increases bank financial resilience through greater capital efficiency and mitigates systemic risks;
    - Addresses market concern about overreliance on the Fed RRP by liquidity investors and possible market dislocations in a stress event;
    - Adds a needed "safe asset" option for liquidity investors; and
    - No need for maturity, liquidity or credit transformation.

<u>Considerations for the Commission:</u>

The potential attributes of a swap-based fund are hopefully sufficiently persuasive to conclude that there would be public benefit to the Ives Suggested Amendment to the Arca proposal.

In addition to that, the following factors are cited to show how the Amendment is compatible to other objectives of the Commission:

- Granting the Arca proposal with the Ives Suggested Amendment would foster capital formation by facilitating market access for new products and innovative, competitive investment company structures that are consistent with investor protection.

- Swap-based funding from an investment company has attributes not found in other investment products and would expand bank access to funding and capital management to support capital formation.

- The Commission in 2014 introduced new rules regulating money market funds to reduce susceptibility to runs and better manage redemptions in times of stress. With its different approach, a swap-based portfolio strategy advances these objectives.

- The Commission recognizes the need to mitigate any unintended consequences arising from reform. The development of swap-based funding is a new approach to help to restore market liquidity and to create new "safe" asset investment options.

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(see next page)

I am hopeful that this letter presents a persuasive case to accept the Arca proposal with Ives Suggested Amendment. Acceptance will increase the public benefit and maintain investor protections.

If you have any questions or require more information, please do not hesitate to contact me.

Very truly yours,

cc: The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar

Mr. David Grim, Director
Division of Investment Management