



May 1, 2020

**VIA ELECTRONIC SUBMISSION**

Vanessa Countryman  
Secretary  
U.S. Securities and Exchange Commission  
100 F St., NE  
Washington, DC 20549-1090  
File No S7-24-15; RIN: 3235-AL60

**Re: Release No. 34-87607; File No. S7-24-15 Proposed Rule on Use of Derivatives by Registered Investment Companies and Business Development Companies**

Dear Ms. Countryman:

The Securities and Exchange Commission (“SEC” or “Commission”) is requesting comment on a proposal for a new comprehensive regulatory approach to the use of derivatives by mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and companies that elect to be treated as business development companies (“BDCs”) under the Investment Company Act (collectively, “funds”) (the “Proposal”).<sup>1</sup> As a leader in exchange-traded derivatives, Cboe Global Markets, Inc. (“Cboe”) appreciates the opportunity to provide feedback on the Proposal. Cboe understands that the overarching objectives of the Proposal are to better address speculation and asset sufficiency concerns underlying Section 18 of the Investment Company Act<sup>2</sup> related to derivatives use by funds, and to create safeguards for certain funds that present risks to their investors through derivatives exposures. With those objectives in mind, Cboe’s comments are focused on ensuring that aspects of the Proposal do not unduly limit the ability of funds to effectively use exchange-traded options (“listed options”).

Cboe is the creator of listed options, and operates four U.S. options exchanges (Cboe Options, C2 Options, BZX Options, and EDGX Options), including the largest U.S. options exchange (Cboe Options); a futures exchange (CFE); four U.S. stock exchanges (BYX Equities, BZX Equities, EDGA Equities, and EDGX Equities); one of the largest pan-European stock exchanges (Cboe Europe Equities); and, a foreign

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<sup>1</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies, Securities Exchange Act Release No. 87607 (November 25, 2019), 85 FR 4446 (January 24, 2020).

<sup>2</sup> Proposal at 4453.

exchange-trading platform (Cboe FX). Cboe sets the standard for options and volatility trading through product innovation, trading technology, and investor education. Cboe offers options and futures trading on various market indexes as well as options on the stocks of individual corporations and exchange-traded products, such as ETFs and exchange-traded notes. While Cboe offers trading in a wide array of asset classes, the focus of the comments in this letter relate to options.

### **Executive Summary**

- **The Proposal meaningfully improves upon a previous proposal concerning funds' use of derivatives contemplated by the Commission.**
- **Cboe applauds the Commission's focus on investor protection, however, Cboe urges the Commission to craft any final rule in as targeted a way as possible so as to not hinder the ability of funds to optimally utilize listed options. Exchange listed options are powerful and useful investment tools and their benefits should be enjoyed by a wide spectrum of investors.**
- **To avoid being unnecessarily broad, the Proposal should not encompass options and options strategies that do not result in a future payment obligation and therefore do not present the risk of undue speculation.**
- **The proposed sales practice rules for leveraged and inverse funds are duplicative in many ways when viewed in combination with recently approved SEC Regulation Best Interest (Reg BI).**

### **Cboe Recommendations**

- a. *Funds that utilize listed options often have lower volatility and less severe drawdowns than other funds and as a result, any restrictions or requirements regarding the use of derivatives by funds should be tailored as narrowly as possible to not hinder funds and individual investors from realizing the value provided by listed options.*

For years, exchange-listed derivatives have been widely embraced by advanced investors, including financial professionals, institutional investors, and knowledgeable self-directed individual investors. Cboe believes the proposed measures should not hinder individual investors' access to important financial tools and strategies that institutional investors have used to manage risk for years. Retail investors are increasingly enjoying the same opportunities and access to these types of strategies that previously were only enjoyed by institutional investors. A significant force behind this positive trend is the use of derivatives by funds.

Some funds, as mentioned earlier, utilize options to efficiently hedge their holdings, manage risk, and improve returns. This should be encouraged as it benefits shareholders of these funds. Similarly, funds are increasingly offering cost-effective and efficient ways to obtain unique derivative-driven exposures that otherwise might be more challenging for the average investor to replicate on her/his own. This

cost-effective access to these exposures, coupled with the recent move of many of the predominant retail brokers to zero commissions, has resulted in a broader array of market strategies that are more accessible to Main Street investors than ever before.

The first SEC-registered funds that were focused on using options were launched in 1977 in the U.S. and this category of funds has grown substantially, especially over the past 15 years.<sup>3</sup> Specifically, the number of options-based funds grew from 10 in 2000 to 157 in 2017, and the assets under management of those funds increased from \$4.1 billion to \$54 billion, respectively.<sup>4</sup> Cboe has a specific interest in the performance of options-based funds and sponsored a study by the Institute for Global Asset and Risk Management regarding the performance of options-based funds. This study analyzed the equal-weighted performance of options-based funds that made significant use of U.S. stock index options and/or equity options from 2000 through 2017 and found that: (1) the options-based funds had substantially lower annualized standard deviations (by 3.2 to 12.3 percentage points) than the Treasury Bond (Citi), S&P 500, MSCI EAFE, and S&P GSCI Indexes; (2) the options-based funds had lower maximum drawdowns than the S&P 500, MSCI EAFE, and S&P GSCI Indexes; (3) the options-based funds had higher annualized returns than the S&P GSCI and MSCI EAFE Indexes; and (4) the options-based funds had higher risk-adjusted returns (as measured by the Sharpe Ratio, Sortino Ratio, and Stutzer Index) than the S&P GSCI and MSCI EAFE Indexes.<sup>5</sup> It is important to note that during the 17-year period, **options-based funds had lower volatility and less severe drawdowns** than the S&P 500 and S&P GSCI Indexes.<sup>6</sup>

The study also concluded that the use of options by mutual funds yields higher risk-adjusted performance compared to funds that do not use options.<sup>7</sup> Similarly, a 2014 study conducted by Goldman Sachs found that over a 5-year period, funds that used options had higher returns, lower volatility, and higher risk-adjusted returns than their peer funds that did not use options.<sup>8</sup> More recently, the markets have been experiencing levels of significant volatility in connection with the COVID-19 virus. In light of that recent volatility, the S&P 500 Index experienced a decline of 13.22% in its total return over the period of February 24 through April 22. During that same time period of increased market volatility, certain funds that track either the S&P 500 Index or ETFs related to the S&P 500 Index through the use of listed options and provide a buffer of downside protection against losses

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<sup>3</sup> Keith Black and Edward Szado. *Performance Analysis of Options-Based Equity Mutual Funds, Closed-End Funds, and Exchange-Traded Funds*, The Journal of Wealth Management, (2016), Vol. 19.

<sup>4</sup> Id.

<sup>5</sup> Id.

<sup>6</sup> Keith Black and Edward Szado. *Performance Analysis of Options-Based Equity Mutual Funds, Closed-End Funds, and Exchange-Traded Funds: An Update*, The Journal of Wealth Management, (2018). In addition, another study that found lower volatility: Markus Natter, Martin Rohleder, Dominik Schulte, and Marco Wilkens, *The Benefits of Option Use by Mutual Funds*, Journal of Financial Intermediation, (April 2016), Vol. 26, 142-168.

<sup>7</sup> Id.

<sup>8</sup> Goldman Sachs Research, *Mutual Fund Use of Options: Public Holdings and Trends* (2014).

over a set period of time while also providing predetermined capped growth opportunity, only experienced declines in total returns ranging from around 6% to 9%. This further demonstrates the value that derivatives can bring to funds, especially during times of market volatility.

Cboe agrees with Commissioners Peirce and Roisman that “derivatives are essential financial tools in today’s markets” and “if funds were prohibited from using derivatives, investors would incur higher costs and greater risks for the same market exposure.”<sup>9</sup> Prudent use of options and capitalizing on their efficiencies should be embraced. Indeed, the Proposal rightly acknowledges that “funds use derivatives to seek higher returns through increased investment exposure, to hedge risks in their investment portfolios, or to obtain exposure to particular investments or markets more efficiently than may be possible through direct investment.”<sup>10</sup> These important benefits must not only be preserved, they should be realized by a broader spectrum of investors. Cboe believes that funds should not be unduly discouraged from using options and the Proposal’s scope should be as targeted as possible, including consistent with the recommendations that follow.

- b. Rule 18f-4 should clearly exclude from its scope derivatives strategies that do not result in a future payment obligation and therefore do not present risk of undue speculation.*

Cboe believes that certain types of derivatives should be clearly excluded from the Proposal’s definition of “derivatives transaction.” As proposed, a *derivatives transaction* is any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument, 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; and short sale borrowing.<sup>11</sup>

While not explicit in the definition, footnote 85 of the Proposal states that “a fund that purchases a standard option traded on an exchange, for example, generally will make a nonrefundable premium payment to obtain the right to acquire (or sell) securities under the option. However, the option purchaser generally will not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option.”<sup>12</sup> The Proposal does not expand on this point sufficiently. It is an important point. Cboe believes that the definition of *derivatives transaction* should not include instances where a fund holds options that do not collectively impose a future payment obligation on the fund.

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<sup>9</sup> See Statement on the Re-Proposal to Regulate Funds’ Use of Derivatives as Well as Certain Sales Practices (November 26, 2019).

<sup>10</sup> Proposal at 4448.

<sup>11</sup> Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), 80 FR 80883 (Dec. 28, 2015) (the “2015 Proposal”) at 39.

<sup>12</sup> Proposal at 40.

There should be no ambiguity with respect to the definition of *derivatives transaction* in the Proposal. Purchased options, including purchased options spreads and covered calls, should not be in scope for this proposal and should be expressly excluded from the definition of *derivatives transaction*. Buying an option does not result in any subsequent obligation to deliver cash or assets to the counterparty. Similarly, a fund that uses a strategy that involves multiple options that when combined result in the same effect of having no future payment obligation on the fund should also be out of scope of the Proposal. For example, when a sold put option is combined with a purchased put option to create a standard purchased options spread, there is no net future payment obligation created by the options spread because any future payment obligation created by the sold put option will not be greater than the potential payment of the purchased put option. Similarly, covered calls when viewed holistically do not impose a future payment obligation. When viewed in isolation, a sold call option does create a future payment obligation; however, when viewed in combination with the underlying security position, the future payment obligation shouldn't exceed the value of the underlying security. Accordingly, long put spreads, long call spreads, and covered calls should be clearly excluded from the definition of *derivatives transaction* under the Proposal. Many target outcome funds utilize options well in excess of the *limited user of derivatives* threshold, but do not put the fund at risk via future payment obligations beyond the known maximum downside, and should therefore also be out of scope of the Proposal.

- c. *The proposed sales practice rules for leveraged and inverse funds are duplicative in many ways when coupled with Reg BI.*

The new sales practice rules in the Proposal mandate that all broker-dealers and SEC-registered investment advisers require that investors seeking to transact in leveraged or inverse funds complete a specified list of questions to determine if they are capable of understanding these products. These sales practice rules would apply to an individual who wishes to transact in these products on his/her own as well as to a broker-dealer that has discretion over a client's account (the broker-dealer could not trade in these products on behalf of its client until this due diligence has been completed). Clearly, the inclusion of the new sales practices for leveraged and inverse funds, may limit investors' access to these products as some brokers may be less willing to continue offering them to customers due to the increased burden associated with the new sales practices.

Cboe feels that the proposed sales practice rules are potentially duplicative of parts of recently approved Reg BI, which requires broker-dealers to only recommend products that are in the best interest of a customer while considering the customer's investment profile, the potential risks, rewards, and costs of the recommendation and that are based on a reasonable understanding of the client's objectives.<sup>13</sup>

Today, recommendations to customers of leveraged and inverse ETFs by firms must be suitable and based on a full understanding of the terms and features of the product and sales materials must be fair and accurate. In addition to presenting a balanced overview of the risks and benefits associated with

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<sup>13</sup> Regulation Best Interest: The Broker-Dealer Standard of Conduct, Securities Exchange Act Release No. 86031 (June 5, 2019), 84 FR 33318 (July 12, 2019).

the particular leveraged or inverse product, firms and registered representatives supervised by FINRA must specifically disclose that the fund is not designed to, and will not necessarily, track the underlying index or benchmark over a longer period of time in all of their sales materials and oral presentations regarding these products.<sup>14</sup> A firm or registered representative must perform a reasonable basis suitability determination before recommending a transaction or investment strategy involving a security pursuant to FINRA's suitability rule.<sup>15</sup> FINRA's heightened supervision of complex products<sup>16</sup> paired with the newly finalized Reg BI rule make the new sales practices for leveraged and inverse products in the Proposal duplicative and potentially unnecessary.

Cboe agrees with the statement made by Commissioners Peirce and Roisman in that investors should not have their ability to access the full range of asset classes and products available in our public markets limited.<sup>17</sup> As such, Cboe recommends that the Commission wait until Reg BI has been fully implemented before proceeding with any further sales practice rules to see if the Commission's concerns can be addressed by Reg BI.

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Cboe appreciates the opportunity to share its views on the Proposal. Cboe believes that the Proposal should not encompass options and options strategies that do not result in a future payment obligation and therefore do not present the risk of undue speculation. Additionally, Cboe is concerned that the new sales practice requirements are duplicative when viewed in combination with Reg BI and as a result, investors may be forced to pay higher fees for access to such strategies due to the additional costs and ramifications associated with the Proposal. Cboe welcomes the opportunity to discuss these comments further.

Sincerely,



Angelo Evangelou  
Chief Policy Officer  
Cboe Global Markets, Inc.

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<sup>14</sup> FINRA Regulatory Notice 09-31, FINRA Reminds Firms of Sales Practice Obligations Relating to Leveraged and Inverse Exchange-Traded Funds <https://www.finra.org/rules-guidance/notices/09-31>.

<sup>15</sup> See FINRA Rule 2111.

<sup>16</sup> FINRA Regulatory Notice 12-03, Heightened Supervision of Complex Products states that any product with multiple features that affect its investment returns differently under various scenarios is potentially complex.

<sup>17</sup> See Statement on the Re-Proposal to Regulate Funds' Use of Derivatives as Well as Certain Sales Practices (November 26, 2019).

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cc:

Securities and Exchange Commission

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The Honorable Hester M. Peirce, Commissioner

The Honorable Elad L. Roisman, Commissioner

The Honorable Allison H. Lee, Commissioner

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