CBOE

November 7, 2011

<u>Via Electronic Mail</u>
Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: Comment Letter on Release No. IC-29776 Relating to Use of Derivatives by Investment Companies Under the Investment Company Act of 1940; File No. S7-33-11; RIN 3235-AL22; 76 FR 55237 (September 7, 2011)

Dear Ms. Murphy:

Chicago Board Options Exchange, Incorporated ("CBOE" or "Exchange") appreciates the opportunity to provide its comments to the Securities and Exchange Commission ("SEC") with respect to the SEC's concept release referenced above ("Release"). The SEC is reviewing the use of derivatives by management investment companies registered under the Investment Company Act of 1940 ("IC Act") and companies that have elected to be treated as business development companies under the IC Act (collectively "funds"). To assist in the SEC's review, the SEC issued the Release soliciting comments on a wide range of issues relevant to use of derivatives by funds. The SEC stated that the comments received will assist in its evaluation of the current regulatory scheme governing the use of derivatives by funds.

CBOE operates the nation's largest securities options exchange under the SEC's jurisdiction. In addition, CBOE affiliates, C2 Options Exchange, Incorporated and CBOE Futures Exchange, LLC, operate all electronic options and futures markets, respectively. Accordingly, our comments are based on our experience in operating markets for exchange-traded derivatives for both options and futures.

The Growth and Benefits of Derivatives Trading

The Exchange believes that the use of derivatives by funds is a natural step in the evolution of fund offerings and is reflective of an overall growing interest in derivatives generally. In recent years, the Exchange has observed a greater sophistication and understanding of derivatives by market participants than ever before. CBOE believes this is due to cost effective access to derivatives markets; greater availability of information and analytics; and the willingness of brokers to actively support derivatives trading, primarily through broker training and investor education.

The innovative use of derivatives by funds in recent years has extended new investment opportunities and diversification benefits to a rapidly growing number of investors. These funds have created access to strategies and asset classes that would otherwise have been unavailable to the majority of investors just a few years ago. The Exchange generally favors this "democratization" of derivatives, yet recognizes the need for adequate financial safeguards and risk disclosure for funds that hold derivatives, using the same guidelines that work for other investments.

Fund Use of Derivatives

Funds that use derivatives do so in order to create unique economic exposures in an efficient and cost-effective manner. In accomplishing these goals, funds choose whether to use derivatives that are traded either over-the-counter ("OTC") or derivatives listed on an exchange. The hallmarks of OTC derivatives trading include customized bi-lateral trading in contracts privately between the parties without the use of central clearing. As a result, each party to an OTC derivatives transaction is subject to the credit risk or possible default by the other party.[1]

The Exchange believes that exchange-traded derivatives are more appropriate for use by funds registered under the IC Act for a number of reasons. First, listed derivatives offer transparent pricing during the trading day as a result of real time dissemination of bids and offers and reports of completed transactions. This enables investors to observe the market prices of derivative contracts held by funds at any time during the trading day. Second, exchanges are centralized markets that provide buyers and sellers with greater opportunities to initiate and close out positions at the best available prices. This is because market participants compete continuously for the best prices and investors can be reassured that fund managers are making their derivatives trades at "best execution" prices. Third, listed derivatives are subject to clearing and investors can feel confident that clearinghouses will subject their investments to objective valuations and adequate risk management practices. In addition, funds that use listed derivatives substantially mitigate counterpart risk through the use of central clearing. Finally, listed derivatives are subject to regulations and oversight that provide enhanced investor protection and market surveillance.

The Exchange understands that some funds which have complex payout features (such as leveraged funds) or funds with exposure to less liquid markets may enter into OTC swap agreements in order to increase efficiency and minimize trading costs. Funds using OTC derivatives, however, face the dual challenge of adequately disclosing the complexity of the funds' market risks as well as the nuances of counterparty credit risk. As mentioned above, funds that use listed derivatives, however, need not raise the issue of counterparty risk with their investors as it is virtually eliminated through clearing and a separate risk disclosure regime is already established respecting listed derivatives.[2]

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[1] See e.g., Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 (2010) (the "DFA"). The Exchange notes that the DFA contained sweeping reforms regarding the trading and clearing of certain kinds of OTC derivatives (swaps).

[2] See e.g., Characteristics & Risks of Standardized Options, also known as the options disclosure document ("ODD") available at: http://www.theocc.com/about/publications/character-risks.jsp.

Regardless of where derivatives are traded, they provide market participants with valuable tools to manage and reduce financial risk, and, because of the leverage involved, permit risk management strategies to be accomplished without the capital outlay required if trading in the underlying instrument occurred. To the extent the SEC determines to modify the existing regulatory regime regarding the use of derivatives by funds, the Exchange strongly encourages the SEC to craft regulations that do not create regulatory arbitrage to the disadvantage of listed derivatives. For example, if the SEC limits a fund's ability to trade certain types of exchange traded derivatives, a similar type of restriction should apply for comparable products traded OTC. Given the increased risks associated with trading OTC derivatives, the SEC may consider assigning a higher standard for the use of OTC derivatives by funds during its evaluation. At a minimum, the Exchange supports comparable capital treatments for derivatives traded on or off exchange.

Leverage and Risk

The Exchange believes that any analysis related to leverage and risk should focus on the fund portfolio in its entirety rather than on any single derivative contract held by that fund. Funds use derivatives to create unique economic exposures; that is, unique risk / reward profiles. One example of such a unique exposure is a fund that delivers twice or three times the daily return of an underlying index such as the S&P 500 Index – a so-called "leveraged" fund. Another example is a fund that systematically sells one-month call options against an S&P 500 Index stock portfolio – a "covered call" fund. Both funds use derivatives that provide leverage and both funds are linked to the same underlying index. Yet their respective economic exposures and risks are quite different: the "leveraged" fund is by design more volatile (i.e., risky) than the S&P 500 Index alone, and the "covered call" fund is by design less risky than the S&P 500 Index alone.

The Exchange is unaware of any fund that holds derivatives exclusively and believes that all funds hold derivatives *plus* either cash or an underlying asset that collateralizes the fund portfolio. The collateral reduces the leverage inherent in derivative contracts, and prevents a fund's net asset value ("NAV") from going negative. In the example of the "covered call" fund, the call option is fully collateralized and the leverage of the combined portfolio is actually less than the leverage of the individual fund components.

The Exchange favors a risk-based framework for determining appropriate collateral levels for funds that hold derivatives. This approach is analogous to the risk-based haircut / portfolio margining method granted to market-makers and certain customers, which has been proven effective though many financial crises. The Exchange believes that requiring funds to post collateral equal to the "notional amount" of a transaction is unnecessarily restrictive and capital in-efficient. Additionally, a risk-based framework can be applied over a broad range of derivative exposures, thereby reducing regulatory uncertainty for new derivative instruments and exposures.

All investments have risk and the Exchange believes that the SEC should not single out funds that use derivatives for special treatment. Even among funds that do not use derivatives, there is a broad spectrum of risks. For example, a fund that holds 2-year Treasury Notes is arguably less risky than a fund that holds emerging market sovereign debt. Similarly, the S&P 500 Index stock portfolio "covered call" fund described above has less risk than an S&P 500 Index stock fund with no derivative exposure.[3]

Securities investors have had access to investments with embedded optionality long before the first fund entered into its first derivative transaction. Several years ago and continuing up until today, banks and other entities have issued structured notes linked to the performance of an underlying stock, index or other asset. The modern version of these products, exchange-traded notes ("ETNs") are able to feature risk / return profiles that are virtually identical to a comparable IC Act fund. Moreover, few investors appreciate the fact that an issued note and a comparable fund, while having similar market exposure, have different risks due to the possibility of issuer default. Therefore, the Exchange strongly urges the SEC to maintain a "level playing field" and to avoid imposing regulations that would create barriers to entry for funds based solely on the fact that they use derivatives.

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We appreciate this opportunity to present our views. Please feel free to contact William Speth in our Research and Product Development Department at (312) 786-7141 or Jennifer Klebes at (312) 786-7466 in our Legal Division if you have any questions regarding our comments.

Sincerely,

Edward T. Tilly
President and Chief Operating Officer
Chicago Board Options Exchange, Incorporated

cc: Joseph Levin (CBOE)
Joanne Moffic-Silver (CBOE)

[3] CBOE calculates a number of BuyWrite benchmark indexes, including the CBOE S&P 500 BuyWrite Index ("BXM"). Information regarding these indexes and a detailed description of the BXM methodology may be accessed at: http://www.cboe.com/micro/bxm/