

Limited Derivatives Users—Applying the Currency Hedging Exclusion

Our [last two posts](#) surveyed what [Rule 18f-4](#) and its adopting release (the "[Release](#)") tell us about excluding currency and interest-rate derivatives from the derivatives exposure of a fund seeking to comply with the [Limited Derivatives User](#) requirements of Rule 18f-4(c)(4). The Release indicates that the SEC intends to exclude only those derivatives that:

will predictably and mechanically provide the anticipated hedging exposure without giving rise to basis risks or other potentially complex risks that should be managed as part of a derivatives risk management program."

This post considers questions we have encountered in applying this exacting standard to currency hedging strategies.

A Paradigmatic Bond Hedge

We begin with an example of a "perfect" currency hedge. A fund holds a non-coupon bearing one-year note for €10 million. To hedge its currency risk, the fund enters into a deliverable forward contract to exchange €10 million for \$11.8 million on the same day the note matures. This hedge effectively locks in the fund's return as the difference between the dollar value of the purchase price and \$11.8 million. The return before maturity should be the accreted discount (or, in the negatively yielding euro world, amortized premium) based on this difference. If held to maturity, the fund can apply €10 million received from the note to the forward contract and receive \$11.8 million, which will "mechanically" produce the predicted return. We are less sure that the return from selling the note before maturity and closing out the currency forward will be as predictable or necessarily correspond to the accreted (or amortized) value of the note. But if this currency hedge were not excluded from a fund's derivatives exposure, we find it hard to imagine a hedge that would be excluded.

Equity Hedges

The next example involves a fund holding euro-denominated stocks with a current value of €10 million. The fund enters into 80 of the September 2022 Euro FX Futures to sell a total of €10 million for a total of \$11.8 million. Unlike the bond example, there is no fixed date on which the fund expects to receive €10 million; this is just the amount it could raise by selling the stocks for their last traded price. So, this does not seem to be a "mechanical" hedge. Nevertheless, paragraph (c)(4)(i)(B) explicitly excludes currency hedges of equity investments from a fund's derivatives exposure and uses the value of such investments to measure the notional amount excluded. This suggests that a fund could also exclude currency derivatives that settle or expire before the maturity date of a hedged fixed-income investment. Excluding currency derivatives with terms extending beyond the maturity date may be problematic, however, if the hedge would entail material [basis risk](#).

Hedging Purchases

Our examples assume a fund is hedging investments it already holds, since paragraph (c)(4)(i)(B) covers

derivatives that hedge currency or interest rate risks of a specific investment held by the fund. But what about a derivative that hedges a commitment to purchase an investment? What if a fund agrees to purchase €10 million of securities on a "when-issued" basis with settlement to occur within 30 days? If the euro appreciates against the dollar in the interim, the fund could pay more (in dollar terms) than it bargained for. To hedge this risk, the fund could enter into a 30-day currency forward to purchase €10 million for \$11.7 million. Should this forward count towards the fund's derivatives exposure? Note that the "when-issued" trade would [not be a senior security under 18f-4\(f\)](#) so long as the fund expects to physically settle within 35 days. But paragraph (f) only permits a fund to "invest in a *security* on a when-issued or forward-settling basis." Euros are not securities, so paragraph (f) would not apply to the currency forward. The forward contract also would not qualify as an unfunded commitment under paragraph (e) because: (1) [currency forwards are derivative contracts](#), and (2) the forward is not a [commitment to make a loan or invest in equity](#). Nonetheless, we believe the fund may exclude this type of currency forward from its derivatives exposure. Paragraph (c)(4)(i)(B) allows a Limited Derivatives User to exclude derivatives that "hedge currency ... risks *associated* with one or more specific ... investments held by the fund." The when-issued trade, which would be included in the fund's net assets [not later than the next business day](#) after the trade, should be an "investment held by the fund," and appreciation in the dollar value of its purchase price is a risk "associated" with this investment, so the fund should be permitted to exclude a currency forward hedging this risk from its derivatives exposure. Our next post examines even knottier problems regarding interest-rate hedges.

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