

March 28, 2016

Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies [File No. S7-24-15]

Dear Mr. Fields,

The Foreign Exchange Professionals Association (“FXPA”)¹ appreciates the opportunity to provide comments to the Securities and Exchange Commission (“SEC” or “Commission”) on proposed rules on the Use of Derivatives by Registered Investment Companies and Business Development Companies under the Investment Company Act of 1940 (“Investment Company Act”) (the “Proposed Rules”).²

The FXPA appreciates the Commission’s review and analysis of funds’ use of derivatives, and its underlying motivation to require funds to implement risk management measures for better investor protections. The FXPA supports the Commission’s efforts to protect investors and applauds attempts to “provide an updated and more comprehensive approach to the regulation of funds’ use of derivatives transactions and other transactions . . . in light of the dramatic growth in the volume and complexity of the derivatives markets over the past two decades and the increased use of derivatives by certain funds.”³

After reviewing the Proposed Rules, however, the FXPA respectfully submits that foreign exchange (“FX”) forwards and FX swaps (collectively, “FX Derivatives”) should be exempt from the Commission’s proposed regulatory scheme given the unique nature of these products, which are critical to funds as risk-reducing instruments.

Generally, the FXPA believes that impediments to asset managers’ use of FX Derivatives to hedge commercial risk from global investment strategies could reduce asset managers’ abilities to deploy capital around the world, restricting investment strategies, tying asset managers’ systemic stability to US dollar-denominated investments, and could restrict long-term investment capital to businesses around the world.

The FXPA believes that the US Treasury Department’s determination (the “Determination”)⁴ exempting FX swaps and FX forwards from regulation as swaps under the Commodity Exchange Act (“CEA”) should inform the Commission’s framework for the Proposed Rules.

¹ The Foreign Exchange Professionals Association represents the collective interests of professional foreign exchange industry participants, including asset managers, to advance a sound, liquid, transparent and competitive global currency market to policymakers and the marketplace through education, research and advocacy. The FXPA’s activities focus on educating US and international legislators, regulators and central banks, the news media, and the general public, as well as coordinating with multinational organizations and trade bodies. The following comments do not represent the specific individual opinion of any one particular member.

² Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,884 (Dec. 28, 2015) (“Proposed Rules”).

³ *Id.* at 80,885.

⁴ See Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012) (“Determination”).

The FXPA encourages the SEC to use the same definitions as the US Treasury Department for a “currency swap”⁵ and an “FX swap.”⁶ While the Proposed Rules contemplate FX forwards and currency swaps,⁷ the FXPA’s comments relate solely to the treatment of FX forwards and FX swaps, as defined by the Treasury Department. These products, unlike currency swaps, are different because, as discussed below, the amount of the cash flow exchanged by the party is known at the onset of the transaction and face minimal settlement risk.

Though not addressed in the Determination, the FXPA also believes that the Proposed Rules should exempt FX futures and non-deliverable forwards (“NDFs”). These products are similarly relied upon by funds to reduce currency risk and promote cross-border investment by asset managers. Like FX swaps and FX forwards, these products pose relatively low risk to the financial system due to their liquidity and settlement dynamics and their short dated tenors.⁸

The following comments: (1) describe the role of the global institutional FX market, (2) explain how registered investment companies and business development companies generally use FX Derivatives, (3) reiterate the relevant analysis published by the Department of the Treasury when it determined that FX swaps and FX forwards should not be regulated as swaps under the CEA, and (4) explains how the Proposed Rules’ restriction of the use of FX Derivatives may increase, rather than decrease, systemic risk. The FXPA believes that funds’ use of FX Derivatives, coupled with the unique characteristics of such products, provide reasonable grounds for the SEC to exempt FX Derivatives from the Proposed Rules.

I. The Global Institutional FX Market⁹

The global institutional FX market is a global market in which any two currencies can be traded against each other (subject to convertibility and other rules) in any jurisdiction. The FX market is the largest financial market in the world as measured by average daily volume. In April 2013, average daily volume of the FX market was \$5.3 trillion, up from \$4 trillion in April 2010.

Because there is no national marketplace for an individual currency, quotes and trading take place in a decentralized fashion. The FX market operates around the clock, from the “open” at 5:00am Sydney time on Monday morning until the “close” at 5:00pm New York time on Friday. In 2013, 71.1% of daily activity was handled in four jurisdictions: the UK (40.9%), the US (18.9%), Singapore (5.7%), and Japan (5.6%). Corporations use FX markets to finance cross-border trade, fund offshore subsidiaries and offices, as well as hedge future revenues or expenses. Asset managers generally use the FX market to finance international

⁵ See *id.* at 69,702 (“generally involves a periodic exchange of a floating amount of cash flows between the counterparties based on the value of the underlying variable(s) on which the derivative contract is based”).

⁶ See *id.* (“involves a simple exchange of principal at one point in time and a reversal of that exchange at some later date”).

⁷ See Proposed Rules at 80,902, Table 1.

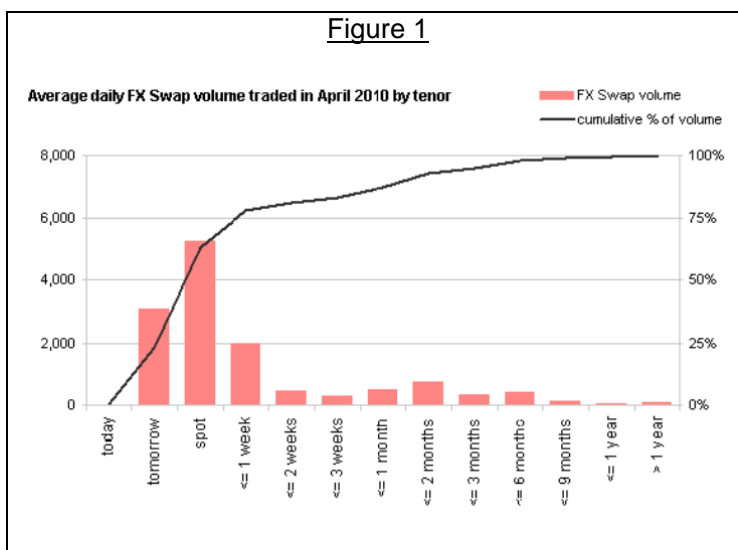
⁸ See Commodity Futures Trading Commission (“CFTC”) Foreign Exchange Markets Subcommittee memorandum to CFTC Global Markets Advisory Committee, December 5, 2014, *available at* http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/gmac_fxndfmandate122214.pdf (“the [Foreign Exchange Markets Subcommittee] concluded that a CFTC clearing mandate for FX NDFs would result in a systemwide reduction of counterparty credit risk, but may not reduce systemic risk in the financial system given the small size (about 2% of the overall FX market) and short-dated tenor (over 90% of [NDF] volumes are transacted in tenors less than 3 months) of the NDF market.”).

⁹ For more information, please see the FXPA’s White Paper “[The Modern Foreign Exchange Market](https://fxpa.org/wp-content/uploads/2015/09/fxpa-overview-7-15.pdf),” *available at* <https://fxpa.org/wp-content/uploads/2015/09/fxpa-overview-7-15.pdf>.

securities transactions, as well as hedge underlying portfolios against future currency movements.

II. Asset Managers Rely on FX Derivatives to Hedge Commercial Risk

As noted in the Determination, FX swaps and FX forwards are “predominantly used as a source of funding to hedge risk associated with short-term fluctuations in foreign currency values and to manage global cash-flow needs.”¹⁰ Recent Bank for International Settlements data demonstrates that a significant portion of FX forwards and FX swaps have tenors less than seven days, and nearly all FX forwards and FX swaps have tenors less than one year.¹¹ As Figure 1 shows, over 75% of daily FX swap volume traded takes place in FX swaps with tenors less than one week.¹²



Based on the FXPA members’ experiences, FX Derivatives are frequently and regularly used by asset managers as risk-mitigating instruments. US-domiciled investors routinely seek to diversify their investments through mutual funds and other investment vehicles. Managers of these funds seek to balance the desire to gain exposure to international assets with the need to mitigate the associated currency risk. Fund managers use a number of instruments to mitigate this currency risk, including FX forward and FX swap contracts. These instruments allow a manager to customize the amount of currency risk they wish to hedge from the portfolio.

For example, consider a manager who has shares of a security denominated in Swiss francs (CHF) in the fund. The manager may decide to hedge 40% of the currency exposure related to this position. If the position is worth CHF 10,000,000, then the manager would sell forward contracts worth CHF 4,000,000. The manager can customize the length of this hedge but the tenor is typically less than three months. In three months, the manager may decide to extend the hedge for another three months by using an FX swap contract.

¹⁰ See Determination at 69,694.

¹¹ See Triennial Central Bank Survey, *Global foreign exchange market turnover in 2013* at 64-65, available at <https://www.bis.org/publ/rpxfx13fxr.pdf>.

¹² See CLS Statistics on Foreign Exchange Activity, October 18, 2010 at 7, available at <http://www.cls-group.com/MarketInsight/CLS%20Information/CLS%20Statistics%20on%20FX%20Activity.pdf>.

This illustration demonstrates when an asset manager may engage in an FX Derivatives transaction to mitigate, rather than increase, risk. As discussed below, these risk mitigating activities are the same activities identified by the US Treasury Department in its Determination to exempt these products from certain regulation pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).

III. The Treasury Department Decided to Exempt FX Swaps and FX Forwards from Certain Dodd-Frank Act Regulations

In November 2012, the Determination exempted FX swaps and FX forwards from regulation as swaps under the CEA due to the “distinctive characteristics of these instruments,” including that “[u]nlike most other swaps, [FX] swaps and forwards have fixed payment obligations, are settled by the exchange of actual currency, and are predominantly short-term instruments.”¹³

The Treasury Department found, among other things, that: (1) FX swaps and FX forwards “differ in significant ways” from other types of swaps; (2) their primary risk—settlement risk—is “effectively mitigated”; and (3) FX swaps and forwards experience less counterparty credit risk.¹⁴ While the Treasury Department undertook this analysis to determine whether these products should be subject to certain Title VII requirements under the Dodd-Frank Act—admittedly for a different purpose than that of the Proposed Rules—the FXPA believes that the unique characteristics of FX swaps and FX forwards identified by the Determination also justify the exemption of these derivatives from the Commission’s Proposed Rules.

In terms of the qualitative differences of FX swaps and FX forwards, the Treasury Department primarily focused on “the certainty of payment amounts and shorter maturities, as well as the market characteristics of these instruments” to find that different regulatory treatment would be appropriate.¹⁵ In particular, the Treasury Department noted that FX swaps and FX forwards are settled physically as counterparties exchange the principal amounts of two currencies, and payment obligations are fixed at the start of the contract, insulating payment obligations from market fluctuations and “contributing to a risk profile that is largely concentrated on settlement risk.”¹⁶ The Treasury Department also observed that FX swaps and FX forwards have shorter maturities than other derivatives with the vast majority maturing in less than one year, causing these products to “carry significantly lower levels of counterparty credit risk [and market risk], relative to other swaps and derivatives.”¹⁷

In terms of the settlement risk of FX swaps and FX forwards, the Treasury Department found that it is “virtually eliminated” through the extensive use of “[payment-versus-payment (‘PVP’)] settlement arrangements, which permit the final transfer of one currency to take place only if the final transfer of the other currency also takes place.”¹⁸ As a result, the Determination states that the minimized settlement risk through the use of such settlement arrangements “constitutes an important, objective difference between [FX] swaps and forwards and swaps that otherwise are subject to regulation under the CEA.”¹⁹ In terms of counterparty credit risk, the Treasury Department also differentiated FX swaps and FX

¹³ See Determination at 69,695.

¹⁴ See *id.* at 69,696-98.

¹⁵ See *id.* at 69,696.

¹⁶ See *id.* at 69,696-97.

¹⁷ See *id.* at 69,697.

¹⁸ See *id.* at 69,698.

¹⁹ See *id.*

forwards from other derivatives by noting that FX swaps and FX forwards involve less counterparty credit risk due to their shorter maturity terms.²⁰

In brief, the characteristics of FX swaps and FX forwards highlighted in the Determination ultimately led the Treasury Department to conclude that the risk profile of such products are unique as compared to other derivatives and, as a result, warrant their exemption from certain Title VII requirements. The FXPA believes that the Commission should also consider these characteristics in the context of the Proposed Rules, as well as previously discussed funds' use of FX swaps and FX forwards, in order to exclude them from the proposed requirements.

IV. Restricting Asset Managers' Use of FX Derivatives May Increase, Rather than Decrease, Systemic Risk

Finally, an across-the-board restriction on funds' derivatives activity, particularly for FX Derivatives, may restrict funds' ability to diversify investments across jurisdictions. As a result, under the Proposed Rules, US asset managers would face more limited investment choices because FX Derivatives would not be readily available to hedge associated currency risks. This means that any volatility in US capital markets could have a more pronounced effect on US funds because their portfolio holdings will be limited to fewer jurisdictions or fewer investment choices rather than more generally diversified across countries and currencies. Limiting a fund's investment choices could also lower overall fund performance.

From a systemic risk standpoint, the FXPA believes that reliance on short-term FX Derivatives to hedge currency risk and promote global investment activity raises fewer concerns than the risks associated with restricting funds' investment strategies to any one currency. And, from a global capital markets perspective, limiting the use of FX Derivatives may also prevent non-US companies from attracting US funds' capital to grow their businesses and benefit from any comparative advantage they may possess. In both cases, these outcomes seem antithetical to the competitive, liquid, and stable global capital markets the SEC seeks to promote.

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Should the Commission wish to discuss these comments further, please contact the undersigned at chairman@fxpa.org.

Sincerely yours,



Chip Lowry
Chairman

²⁰ See *id.*