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March 28, 2016

Ladies and Gentlemen:

We appreciate the opportunity to comment on the Securities and Exchange Commission's proposed new Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940, as amended (the "1940 Act").<sup>1</sup> We would like to draw your attention to the adverse impact that the Proposed Rule would have on the burgeoning currency-hedged index-tracking exchange-traded fund ("ETF") industry, which has attracted significant assets in recent years. As of February 29, 2016, there were 95 currency-hedged ETFs with approximately \$56 billion in aggregate assets under management ("AUM"), which represents about a 382% growth of AUM from this industry's approximate \$14.8 billion in aggregate AUM as of January 1, 2014.<sup>2</sup> We estimate that currency-hedged ETFs attracted approximately \$46.2 billion in new assets during calendar year 2015.<sup>3</sup> This industry growth demonstrates strong demand by U.S. investors for managing risk and return arising from exposure to foreign markets and the related currencies by using ETFs. Our letter is intended to highlight how the Proposed Rule may adversely impact the effectiveness with which currency-hedged ETFs can satisfy this investor demand. In fact, it is possible that if such effectiveness is reduced significantly, investors currently using currency-hedged ETFs may instead make increased use of derivatives directly, outside the scope of the 1940 Act and its investor protections.

For U.S. investors, international investments include two components of return. The first is the return attributable to equity or fixed income prices in the non-U.S. market or markets in which an investment is made. The second is the return attributable to the value of non-U.S. currencies relative to the U.S. dollar. The concept underlying currency-hedged ETFs is to produce a return based mainly on movement in non-U.S. equity or fixed income prices. For currency-hedged ETFs, currency hedging instruments serve to eliminate or minimize currency risk – *i.e.*, currency fluctuations between the U.S. dollar and a specified foreign currency – on a fund's performance, providing fund investors only the return of the applicable foreign security. Towards that end,

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<sup>1</sup> See *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Release No. IC-31933, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf> ("Proposing Release").

<sup>2</sup> Based on information available from Morningstar. As of February 29, 2016, we managed 25 currency-hedged ETFs with approximately \$17.3 billion in assets under management in the aggregate.

<sup>3</sup> Based on information available from Morningstar.

currency-hedged indices assume 100% investment in non-U.S. securities and currency hedging instruments (typically one-month forward currency contracts). In turn, currency-hedged ETFs invest as closely as possible to 100% of their assets in non-U.S. securities and currency hedging instruments in order to track their respective benchmark indices. Typically, such ETFs only maintain minimal amounts of cash or cash equivalents.

## **I. The Proposed Rule presents Particular Issues for Currency-Hedged Index ETFs**

Two elements of the Proposed Rule interact in a manner that would cause particular difficulties for currency-hedged ETFs. First, a currency-hedged ETF's currency hedging derivative transactions would count towards the fund's 150% notional exposure limit ("Exposure-Based Limit") or its 300% risk-based limit ("Risk-Based Limit") imposed under the Proposed Rule.<sup>4</sup> Second, because the ETF's currency-hedging derivative transactions count towards those limits, currency-hedged ETFs would be required under the Proposed Rule to maintain "qualifying coverage assets" in an amount equal to the sum of (i) a mark-to-market coverage amount<sup>5</sup> and (ii) a risk-based coverage amount.<sup>6</sup> The adverse effect on currency-hedged ETFs arises from the stringent proposal to limit "qualifying coverage assets" to cash and cash equivalents.<sup>7</sup> This would dramatically alter the current Commission guidance,<sup>8</sup> pursuant to which - to the extent a fund is required to segregate amounts in respect of its currency hedging activities in order to comply with the limitations of Section 18 of the 1940 Act<sup>9</sup> - the fund may use liquid assets of

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<sup>4</sup> Proposed Rule 18f-4(a)(1).

<sup>5</sup> The mark-to-market coverage amount for a particular derivatives transaction would equal the amount that would be payable by the fund if it were to exit the derivatives transaction at the time of determination. *See* Proposed Rule 18f-4(c)(6).

<sup>6</sup> Proposed Rule 18f-4(a)(2). The risk-based coverage amount for a particular derivatives transaction is an amount, in addition to the derivative transaction's mark-to-market coverage amount, that represents a reasonable estimate of the fund's potential obligation payable if the fund were to exit the derivatives transaction under stressed conditions. *See* Proposed Rule 18f-4(c)(9).

<sup>7</sup> Proposed Rule 18f-4(c)(8). In the Proposing Release, the Commission indicates that current U.S. generally accepted accounting principles would be used to determine what qualifies as "cash equivalents" and provides as examples certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds.

<sup>8</sup> *See* Merrill Lynch Asset Management, L.P., SEC Staff No-Action Letter (July 2, 1996) (permitting segregation of any "liquid assets," including equity securities and non-investment grade debt securities) (the "Merrill Lynch letter").

<sup>9</sup> *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 18, 1979); Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) and the Merrill Lynch letter, note 8 *supra*.

any type, including stocks or bonds in its portfolio, assuming such assets are “liquid” as that term is understood under the 1940 Act.<sup>10</sup>

For currency-hedged ETFs, the requirement to maintain cash or cash equivalents as “qualifying coverage assets” would limit their ability to achieve their investment objectives and strategies, as discussed above. Requiring such ETFs to hold cash or cash equivalents would make it more difficult, if not impossible, for currency-hedged index ETFs to track accurately their respective indices by adding a “cash drag” on the absolute performance of such funds that otherwise would be fully invested. As noted above, the indices tracked by currency-hedged ETFs would not include the cash or cash equivalents required to be held by the ETFs as “qualifying coverage assets,” and ETFs that are required to hold such assets thus would experience structural “tracking error” (the difference between the performance of an ETF and that of its underlying benchmark), which could be substantial.

As an example of the structural tracking error that would result under the Proposed Rule, we present the following two scenarios, one showing negative tracking error and one showing positive tracking error, respectively, in which a currency-hedged ETF would be required to hold cash or cash equivalents equal to the mark-to-market and risk-based coverage amounts for each derivative transaction (e.g., forward currency contract). We assume the sum of the mark-to-market and risk-based coverage amounts would equal a hypothetical 10%<sup>11</sup> of the assets in a currency-hedged ETF as follows:

<b>Tracking Error Examples</b>		
	<b>Scenario 1</b>	<b>Scenario 2</b>
<b>Hypothetical Index performance</b>	+10%	-10%
<b>Amount of ETF’s portfolio invested in index components</b>	90%	90%
<b>Estimated portfolio performance</b>	+9%	-9%
<b>Tracking difference</b>	-1%	+1%

In each scenario, because the fund must segregate cash or cash equivalents in an amount equal to the sum of the mark-to-market and risk-based coverage amounts, the fund is underinvested in the component securities of its index, resulting in a 1% divergence, or tracking error, with respect to its index. This is in marked contrast to the tracking difference a fully-replicated ETF would be

<sup>10</sup> See the Merrill Lynch letter, note 8 *supra*.

<sup>11</sup> This hypothetical 10% performance number is for illustrative purposes only and is not intended to be representative of the performance of any of our currency-hedged ETFs’ respective underlying indices.

expected to incur currently, which we typically estimate to be a low, single-digit basis point number, *e.g.*, due to the ETF's expenses. It is worth noting that despite the positive tracking error shown in Scenario 2, such a divergence from the fund's index is nonetheless still in conflict with the fund's investment objective to track its index as closely as possible. As demonstrated above, significant underinvestment alters the risk profile of the ETF's portfolio and may diminish the usefulness of ETFs for existing and potential investors. Generally, ETF investors expect to see low degrees of tracking error against the ETF's underlying index; we therefore are concerned that the Proposed Rule's adverse impact on currency-hedged ETFs, as described above, would be at odds with ETF investors' expectations.

These particular issues faced by currency-hedged ETFs can be addressed if the Proposed Rule is revised in either or both of the following means: excluding currency-hedged ETFs' currency hedging derivative transactions from the Proposed Rule's exposure limits and/or by expanding the definition of qualifying coverage assets.

## **II. Currency-Hedged ETFs' Currency Hedging Derivative Transactions should be Excluded from the Exposure Limits of the Proposed Rule**

In the Proposing Release, the Commission considered the possibility of excluding certain categories of derivative transactions, including hedging transactions, from the Exposure-Based Limit or Risk-Based Limit, but determined not to exclude any such categories for purposes of the Proposed Rule. The Commission notes that only a small percentage of the funds sampled in a report prepared by the SEC's Division of Economic Risk Analysis would be unable to comply with the Exposure-Based Limit.<sup>12</sup> Accordingly, the Commission's rationale for the Exposure-Based Limit is that such a set limit will "better accommodate the broad diversity of registered funds and the ways in which they use derivatives than a test that would require consideration of the matter in which a fund uses derivatives in its portfolio (*e.g.*, for hedging)."<sup>13</sup>

Under the Proposed Rule, the Commission did not propose adjusting notional amounts on which the Exposure-Based Limit and Risk-Based Limits are based to exclude derivatives such as forward currency contracts that may be used to hedge or cover other transactions. In the Proposing Release, the Commission states that it declined to make such adjustments because it would be difficult to develop a suitably objective standard for such exclusion and that confirming compliance with such standard would pose challenges for both Commission staff and fund compliance personnel. The Commission maintains that because hedging transactions are entered into differently by different entities, describing such transactions for the purpose of a rule of general applicability would be challenging and, furthermore, that many hedges are imperfect and

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<sup>12</sup> See Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost Use of Derivatives by Registered Investment Companies, SEC Division of Economic and Risk Analysis (2015), available at <http://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf>.

<sup>13</sup> Proposing Release at 80964.

may increase leverage or speculative exposure.<sup>14</sup> However, we believe that these objections are not applicable with respect to funds such as currency-hedged ETFs. Currency-hedged ETFs by design hedge the currency risk of their corresponding securities portfolio because currency hedging is built into the methodology of a currency-hedged ETF's index. The Commission therefore should be able to specify an exclusion for such hedging transactions entered into by funds whose purpose is to provide hedged exposure, such as currency-hedged ETFs.<sup>15</sup> The Commission and fund personnel can confirm that a currency-hedged ETF's currency hedging transactions are in fact hedges, rather than transactions that increase leverage or speculation, by confirming that a currency-hedged ETF is tracking its index.

We therefore recommend that the Commission permit the notional amount of hedging transactions entered into for currency hedging purposes to be excluded from the calculation of the Proposed Rule's portfolio limits. Specifically, we recommend that the Commission permit currency-hedged ETFs to exclude the notional amount of currency hedging transactions that reduce the specific risk exposure of a portfolio security or its currency that is directly related to such security or currency and is limited to the total amount of the long position being held. Such hedges are materially the same as direct offsets that reduce or eliminate economic exposure. Providing these limited exclusions for currency hedging transactions would comply with the Commission's policy objective of assuring that funds are not unduly speculative due to derivatives use.

### **III. The Commission Should Expand the Definition of Qualifying Coverage Assets**

In the Proposing Release, the Commission states that the rationale for limiting "qualifying coverage assets" to cash and cash equivalents is because of such assets' extreme liquidity. The Commission further states that other assets, in contrast, could decrease in value at the same time that a fund experiences losses on its derivatives transactions, particularly in times of stressed conditions.<sup>16</sup> However, as noted above, this represents a dramatic change from currently applicable and more flexible Commission guidance<sup>17</sup> allowing a fund to segregate liquid

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<sup>14</sup> See Proposing Release at 80914.

<sup>15</sup> For the avoidance of doubt, it should be noted that while our comments in this letter are focused on currency-hedged ETFs, our comments apply equally to any derivative transaction entered into for hedging purposes. For example, we believe a short derivative transaction correlated with a fund's portfolio holdings to limit the risk of loss should be excluded from the Exposure Based Limit calculation, which we believe is consistent with the Commission's current guidance. See *e.g.*, New England Life Government Securities Trust, No-Action Letter (September 26, 1985) and Z-Seven Fund, Inc., No-Action Letter (May 21, 2984). In each instance, the staff of the Commission indicated that a fund's use of short futures contracts to hedge an existing risk within its portfolio would not give rise to the speculative abuses that Section 18 of the 1940 Act was designed to prevent.

<sup>16</sup> Proposing Release at 80932.

<sup>17</sup> See the Merrill Lynch letter, note 8 *supra*.



portfolio securities to comply with the limitations of Section 18 of the 1940 Act<sup>18</sup> We believe, however, that the long-standing use of a broader range of liquid assets, and not just cash and cash equivalents, has served funds and investors well, including during the 2008-2009 financial crisis and other times of market disruption. We note that, in practice, where a currency-hedged ETF segregates liquid portfolio instruments for its currency hedging transactions, even a substantial decline in the value of such portfolio instruments would not likely prevent the fund from meeting its obligations under the mark-to-market and risk-based coverage amount calculations required under the Proposed Rule. The Proposing Release does not cite any contrary examples relating to currency-hedged ETFs.

#### IV. Conclusion

For the foregoing reasons, we strongly disagree with the Proposed Rule's failure to exclude forward currency contracts used for hedging purposes from its proposed exposure limits and its limited scope of assets that may be used as "qualifying coverage assets." Instead, we urge the Commission to revise the Proposed Rule as follows:

1. Allow funds designed to provided hedged exposure, such as currency-hedged ETFs, to exclude from the calculation of the Exposure-Based Limit and Risk-Based Limit the notional amount of a currency derivative that provides short exposure to the currency in which a security held in a fund's portfolio is denominated, provided the short exposure does not exceed the value of the security being hedged; and
2. expand the Proposed Rule's definition of "qualifying coverage assets" to include those instruments permitted to be used under the Merrill Lynch letter or at least a wider variety of instruments than cash and cash equivalents (such as sufficiently liquid stocks or bonds that are typically held by currency-hedged ETFs).

Currency-hedged ETFs do not give rise to the leveraging concerns underlying the Proposed Rule. Moreover, there is no indication in the Proposing Release that the Commission intended for the Proposed Rule to affect the operations of currency-hedged ETFs (in marked contrast to the Proposing Release's discussions of leveraged and inverse ETFs, as well as "managed futures" funds) or that the Commission views currency hedging activities as particularly speculative.

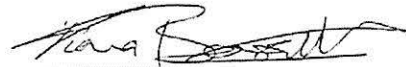
Accordingly, in light of the Proposed Rule's potential material adverse effect on a class of ETFs that has garnered over \$56 billion in assets without any compelling regulatory interest, we urge the Commission to incorporate either or both of our two proposed modifications to the Proposed

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<sup>18</sup> See, e.g., Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (April 18, 1979); Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987) and the Merrill Lynch letter, note 8 *supra*.

Rule in order to enable currency-hedged ETFs to continue to operate in a manner that better enables them to seek to achieve their investment objectives.

Very truly yours,

A handwritten signature in black ink, appearing to read 'Fiona Bassett', written over a horizontal line.

Fiona Bassett  
Chief Executive Officer and  
Chief Investment Officer