THOMSON REUTERS

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April 8, 2016

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

Re: *Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15)*

Dear Mr. Fields:

FX Alliance LLC ("**FXall**") and Thomson Reuters (SEF) LLC ("**TR SEF**"), both wholly-owned indirect subsidiaries of Thomson Reuters Corporation (collectively, "**Thomson Reuters**") welcome the opportunity to submit comments on the Securities and Exchange Commission's ("**SEC**" or "**Commission**") proposed rule on Use of Derivatives by Registered Investment Companies and Business Development Companies ("**Proposed Rule**").[1] Thomson Reuters appreciates the importance of the Proposed Rule to the SEC's investor protection mandate under section 18 of the Investment Company Act of 1940 ("**ICA**"). And Thomson Reuters supports the SEC's initiative to review, and consider updating, its regulations based on current derivatives trading practices of registered investment companies and business development companies (collectively, "**funds**") that would be covered by the Proposed Rule. That such a review is appropriate is demonstrated by the array of no-action letters and interpretations that SEC staff has issued in this area over the years.

We believe, however, that the Proposed Rule's blunt, one-size-fits-all approach fails to appropriately distinguish certain derivatives instruments in the foreign exchange ("**FX**") asset class that do not present the risks to fund investors that are the underlying drivers of the Proposed Rule. As such, the Proposed Rule would inappropriately limit a fund advisor's ability to use these FX instruments on Thomson Reuters' electronic platform to manage risk for the fund and its investors. A more tailored approach is required in this regard. Accordingly, Thomson Reuters respectfully requests that any final rule adopted by the Commission exclude

[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies,* 80 Fed. Reg. 80,884, (Dec. 28, 2015).

FX forwards, FX swaps, non-deliverable forwards involving FX ("**NDFs**"), and FX options (collectively, "**FX Derivatives**") from the definition of "derivatives transaction" based on the distinctive nature of such instruments and the risk-mitigating purposes for which they are used by funds.[2]

## I. Thomson Reuters Background and Interest in the Proposed Rule

Thomson Reuters Corporation is a world-leading source for intelligent information for businesses and professionals. With a global presence in more than 100 countries, Thomson Reuters Corporation combines industry expertise with innovative technology to deliver critical information to leading decision makers in the financial and risk, legal, tax and accounting, science and media markets, powered by the world's most trusted news organization. Thomson Reuters Corporation shares are listed on the Toronto and New York Stock Exchanges.[3]

Subsidiary companies of Thomson Reuters Corporation are leaders in various segments of the dynamic FX market. Our FX Trading Solutions provide access to liquidity in OTC markets, trade execution capabilities and connections for market participants worldwide. They also offer post-trade services globally, enabling banks, brokers and electronic marketplaces to connect seamlessly with their counterparties. Together, they create a major innovative FX provider that offers comprehensive solutions for trade discovery and analysis, execution and post-trade services.

FXall operates an electronic trading, execution, trade processing and negotiation system for foreign exchange spots, forwards, swaps, options and other FX derivative instruments. FXall provides a global electronic platform for institutional FX trading with a broad suite of flexible execution tools, end-to-end workflow management and straight-through processing. Approximately 1,500 institutions globally trade FX instruments in over 500 currency pairs through FXall. These institutions include a range of industrial companies, fund managers, banks, other financial institutions and government and international agencies all over the world. FXall facilitates competitive pricing, internal trading controls, risk management and a granular audit trail. It has succeeded in improving efficiency and transparency, and reducing risk for important FX markets to the U.S. and the world economy. As a result, today a large part of the FX market is traded on electronic systems such as FXall – including less liquid or infrequently traded instruments customized by end-users to meet specific commercial requirements.

TR SEF is registered as a swap execution facility ("**SEF**") with the Commodity Futures Trading Commission (the "**CFTC**"), and currently facilitates electronic trading in NDFs and FX options. TR SEF enables its market participants to trade NDFs and FX options through its request-for-quote and request-for-stream systems and an order book. Market participants benefit from TR SEF's complete end-to-end workflow solution, including straight-through processing and settlement.

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[2] Thomson Reuters also requests that any final rule include rule text directly excluding purchased options (such as FX options) from the definition of a "derivatives transaction." Although this appears to be the intent, which we support, this should be stated in rule text rather than discussed in the narrative preamble.

[3] For more information, please go to www.thomsonreuters.com.

## II. FX Derivatives Should be Excluded from the "Derivatives Transaction" Definition

The Proposed Rule defines a "derivatives transaction" that would be subject to its trading limits and regulatory requirements to mean:

> Any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument ('derivatives instrument') under which the 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 a margin or settlement payment or otherwise.[4]

This letter will respond primarily to the following questions that the Commission has asked with respect to the Proposed Rule's definition of the term "derivatives transaction":

- Is the definition of "derivatives transaction" sufficiently clear? Are there additional types of derivatives instruments that we should include or any that we should exclude?
- The proposed rule's definition of "derivatives transaction" incorporates a list of derivatives instruments, rather than a conceptual definition such as an instrument or contract whose value is based upon, or derived from, some other asset or metric, because we believe that the definition's list of derivatives instruments would more clearly describe the types of derivatives that implicate section 18 [of the ICA] than a conceptual definition. Do commenters agree? Why or why not?[5]

FX Derivatives bear characteristics that are fundamentally different from other derivatives that generate the undue speculation and asset sufficiency concerns that the Proposed Rule identifies as being embodied in section 18 of the ICA.[6] These instruments do not pose the same risk to funds that trade them in comparison to other type of derivatives that fall within the definition of a "derivatives transaction" set out in the Proposed Rule. Accordingly, while we express no opinion on the Commission's decision to define the term "derivatives transaction" by list rather than conceptually, Thomson Reuters requests that if a final rule is adopted which adheres to this approach, FX Derivatives be clearly and expressly excluded from that list. Below, we address each type of FX Derivative, in turn.

### A. The Proposed Rule Fails to Appropriately Consider the Distinguishing Characteristics of FX Forwards and FX Swaps

FX forwards and FX swaps, as defined in the Dodd-Frank Act,[7] should be excluded from the definition of "derivatives transaction." There, Congress defined an FX forward as "a transaction that solely involves the exchange of 2 different currencies on a specific future date at a fixed rate

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[4] Proposed Rule 18f-4(c)(2) under the ICA.

[5] Proposed Rule at 80,900.

[6] *Id.* at 80,890.

[7] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

agreed upon on the inception of the contract covering the exchange." It further defined an FX swap as effectively a combination of two FX forwards, *i.e.*, "a transaction that solely involves—

> (A) an exchange of 2 different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and
>
> (B) a reverse exchange of the 2 currencies described in subparagraph (A) at a later date and at a fixed rate that is agreed upon on the inception of the contract covering the exchange."[8]

Pursuant to authority granted by the Dodd-Frank Act, the Secretary of the US Department of Treasury ("**Treasury**") has issued a determination ("**Determination**") that FX forwards and FX swaps should not be regulated as swaps under the regulatory regime enacted as part of Title VII of the Dodd-Frank Act.[9] Based on evidence that such instruments do not bear the same type and degree of risk that Title VII was enacted to address, Treasury found, as the Dodd-Frank Act required of such a Determination, that FX forwards and FX swaps are "qualitatively different from other classes of swaps,"[10] and it concluded and that they should not be regulated as swaps. And, as a result of this Determination by Treasury, pursuant to rules jointly adopted by the Commission and the CFTC, FX forwards and FX swaps are not considered to be swaps.[11]

We recognize that in making the Determination, Treasury evaluated FX forwards and FX swaps based on statutory criteria set forth in the Dodd-Frank Act that differ from the statutory objectives as set forth in the ICA. Nevertheless, as the Commission seeks to breathe life into statutory language that was enacted over 75 years ago based on current trading realities, the Determination by Treasury stands as the most recent governmental examination of the use of FX forwards and FX swaps in today's markets.[12] It should, therefore, appropriately inform the Commission's consideration of how to treat such instruments when they are entered into by funds.

FX forwards and FX swaps, as recognized in the Determination, involve "a simple exchange of principal at one point in time and [for FX swaps] a reversal of that exchange at some later

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[8] Dodd-Frank Act § 721(a)(2). *See* Sections 1a(24)-(25) of the Commodity Exchange Act ("**CEA**"), 7 U.S.C. §§ 1a(24)-(25). *See also* rule 3a69-2(c)(3)-(4) under the Securities and Exchange Act of 1934 ("**Exchange Act**"); rule 1.3(xxx)(3)(iii)-(iv) under the CEA.

[9] *Determination of Foreign Exchange Swaps and Foreign Exchange Forwards under the Commodity Exchange Act*, 77 Fed. Reg. 69,694 (Nov. 20, 2012).

[10] *See* Dodd-Frank Act § 722(h).

[11] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48,208 (Aug. 13, 2012) ("**Joint Product Definitions Rules**"). *See* rule 3a69-2(c)(1) under the Exchange Act; rule 1.3(xxx)(3)(i) under the CEA. Although FX forwards and FX swaps thus are excluded from the definition of the terms "swap" and "security-based swap," they nevertheless remain subject to the reporting requirements and business conduct standards under the Dodd-Frank Act. *See* rule 3a69-2(c)(2) under the Exchange Act and rule 1.3(xxx)(3)(ii) under the CEA.

[12] The White Paper prepared by Commission staff does not address funds' use of FX forwards and FX swaps in particular. *See* Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost, *Use of Derivatives by Registered Investment Companies*, Division of Economic and Risk Analysis (2015), available at http://www.sec.gov/dera/staff-papers/whie-papers/derivatives1202015.pdf.

date."[13] As a result, the amount of the exchange by each party is known at the onset of the transaction. Because payment obligations in FX forward and FX swap transactions are fixed at the start of the contract, these payment obligations, in contrast to those for other types of derivatives, are insulated from market fluctuations.[14] In addition, most FX forward and FX swap transactions are short-term transactions, with tenors generally less than one year – and often less than seven days.[15]

Based on these significant differences in the characteristics of FX forwards and FX swaps as compared to other types of derivatives, Treasury concluded that these transactions: 1) "carry significantly lower levels or counterparty credit risk [and market risk], relative to other swaps and derivatives;"[16] and 2) bear primarily settlement risk, which is "virtually eliminate[ed]" by virtue of the settlement arrangements used for these transactions.[17] Specifically, the Determination found that:

- FX forwards and FX swaps are subject to less counterparty credit risk than other derivatives because of the short average length of the contracts;[18]
- Because FX forwards and FX swaps settle physically and payment obligations are fixed at the start of the contract, risk associated with the products is largely settlement risk;[19]
- Settlement risk for these transactions, though, has been addressed through the "extensive use of payment versus payment ("**PVP**") settlement arrangements;"[20] and
- Through the use of PVP arrangements, approximately 75 percent of the entire foreign exchange market settles without settlement risk to either party.[21]

Just as these distinctive characteristics of FX forwards and FX swaps persuaded Treasury that they should not be considered swaps generally subject to the swap regulatory regime of the Dodd-Frank Act, so, too, they demonstrate that the Commission should not consider them to be "derivatives transactions" subject to the restrictions and requirements imposed on funds' use of derivatives. Because of their fixed and known payment obligation and short duration, FX

[13] Determination at 69,702.

[14] *Id.* at 69,696-97. Furthermore, foreign exchange rates, upon which the risk of an FX forward or FX swap is based, historically have been less volatile (and thus less risky) than other underlying markets such as equities.

[15] Thomson Reuters concurs with, and supports, the comments submitted on March 28, 2016, by the Foreign Exchange Professionals Association ("**FXPA Letter**"). The FXPA Letter cites data demonstrating that a significant portion of FX forward and FX swap transactions have tenors less than seven days, with the vast majority having tenors of less than one year. FXPA Letter at 3; *see also* Determination at 69,697.

[16] Determination at 69,697.

[17] *Id.* at 69,698.

[18] *Id.*

[19] *Id.* at 69,697-8.

[20] *Id* at 69,698.

[21] *Id*.

forwards and FX swaps do not pose the types of risk identified in the Proposed Rule that are associated with other types of derivatives – *i.e.,* a risk of undue speculation causing a fund to suffer substantial and unforeseeable losses that, through the effects of leverage, render the fund unable to meet its obligations without a forced sale of other investments and, in an extreme situation, even at risk of having to liquidate the fund.[22]

The risks that FX forwards and FX swaps present to funds that trade them are limited, and, importantly, those risks are manageable. To subject them to trading limitations and regulatory requirements designed to address the risk to fund investors from highly-leveraged and longer-term derivatives is unwarranted.[23]

Accordingly, just as the Commission (and the CFTC) concluded on the basis of the Determination by Treasury that FX forwards and FX swaps should be excluded from the class of swaps subject to regulation under the Dodd-Frank Act, the Commission similarly should conclude that they should be excluded from the class of derivatives subject to trading limitations and regulatory requirements when used by funds.

### B. The Proposed Rule Fails to Appropriately Consider the Distinguishing Characteristics of NDFs

NDFs likewise should be excluded from the definition of the term "derivatives transaction" because they are economically and functionally the same as FX forwards (as defined in the Dodd-Frank Act).[24] The sole difference between these two transactions is that in an FX forward, the trade closes out at maturity upon delivery by each party to the transaction of the gross amount of the respective currency specified in the contract. In comparison, in an NDF, the trade closes out at maturity upon delivery of the net value of the underlying exchange, denominated in a pre-determined currency. For example, parties to an FX forward may exchange U.S. dollars (U.S. currency) for, say, British pounds (non-U.S. currency), and in an NDF the paying party pays the difference between the agreed-upon exchange rate for two currencies (*e.g,* US

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[22] Proposed Rule at 80,892-95. In this manner, FX forwards and FX swaps differ from a currency swap which, as stated in the Determination, "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." Determination at 69,702. The fixed nature of a fund's exposure under an FX forward or FX swap transaction, distinguishes it from an exposure to floating metrics underlying derivatives such as currency swaps. For avoidance of doubt, this letter is not addressing currency swaps.

[23] The Proposed Rule notes that when a derivatives instrument does not constitute a "derivatives transaction" and does not involve the issuance of a senior security for purposes of section 18 of the ICA, a fund's advisor nevertheless is expected to consider the potential risks associated with that instrument. Proposed Rule at 80,892 n.83. This should be the case for the FX Derivatives discussed in this letter.

[24] The Determination did not consider whether NDFs should be considered swaps because the Dodd-Frank Act only gave Treasury the authority to exempt FX forwards and FX swaps. *See* Dodd-Frank Act §§ 721(a)(2), 722(h). Similarly, in the Joint Product Definitions Rules, the Commission and the CFTC concluded only that NDFs do not fall within the "plain language in the definition of the term 'foreign exchange forward'" in the Dodd-Frank Act. *See* Joint Product Definitions Rules at 48,256. We recognize that NDFs are not FX forwards. But that is a different question than whether funds that trade NDFs should be subject to the restrictions and limitations as set out in the Proposed Rule, given that NDFs are functionally and economically indistinguishable from FX forwards. For the reasons presented in text, they should not.

dollars/Brazilian real) and the spot rate at settlement. In each structure, the net value transferred would be the value difference between the two currencies exchanged.

NDFs often exist because of capital controls imposed by certain emerging markets that make FX forwards impossible – and not because of any greater benefit associated with NDFs. NDFs are used almost exclusively when one of the underlying currencies cannot be physically delivered or is, as a practical matter, not deliverable offshore as a matter of local law or other local requirements. Non-deliverability is a feature of many emerging market currencies, such as the Brazilian real, Argentine peso, and Russian ruble. As the Federal Reserve Bank of New York explained, "Major NDF market trading began in the early 1990's, initially as a means for companies to hedge their exposure to currency fluctuations of emerging market countries with actual or potential foreign exchange convertibility restrictions."[25] The use of NDFs for this purpose has continued, as evidenced by the fact that "NDF markets in currencies of countries that have allowed increased capital convertibility, to the point where currency hedging is fully available onshore, have dissipated and/or disappeared."[26] This further demonstrates that NDFs and FX forwards are functionally equivalent to one another.

NDFs are a key component of FX markets in non-deliverable currencies, as FX forwards are not capable of being executed in those markets (or, in some markets, it is sufficiently impractical to physically deliver the local currency that would be traded on a forward basis). Indeed, for non-deliverable currencies, an NDF is the only viable means by which to effect a forward transaction. And, just like FX forwards, NDFs typically are of a short duration and mature in much less time than many other types of derivatives.[27] Virtually all mature in one year or less, and over 90% of volumes are transacted in tenors of three months or less.[28]

To be sure, FX forwards involve an exchange of the paired currencies at maturity, whereas NDFs involve a net payment in a specified currency based on spot exchange rates at maturity. However, the distinction between physical settlement in FX forwards and net settlement in NDFs should not be determinative with respect to the issue of limitations and restrictions on funds' ability to make use of these instruments. NDFs essentially are FX forwards where the currency itself is non-deliverable. NDFs bear the same key economic characteristics as FX forwards – short duration, limited exposure to market fluctuations, and no material counterparty or settlement risk. Were one to simultaneously enter into an FX forward and an NDF with identical underlying currencies, notional amount and maturity date, the value of the transactions would be identical throughout their tenor. Thus, the distinction between deliverable FX forwards and net

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[25] Laura Lipscomb, *"Federal Reserve Bank of New York, An Overview of Non-Deliverable Foreign Exchange Forward Markets,"* at 2 (May 2005) ("**Fed NDF Overview**").

[26] *Id.*

[27] *See* Sangita Misra and Harendra Behera, *"Non Deliverable Foreign Exchange Forward Market: An Overview,"* at 30 (Winter 2006) ("for most of the [Asian NDF] currencies, there is limited liquidity in contracts with a maturity over one year.").

[28] CFTC Foreign Exchange Markets Subcommittee Memorandum to CFTC Global Markets Advisory Committee, Response to request for recommendation on an FX NDF mandate, at 3 (Dec. 5, 2014), available at http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/gmac_fxndfmandate122214.pdf.

settlement in NDFs is not a sufficient basis on which to base disparate regulatory treatment of funds' ability to use otherwise identical instruments.

The CFTC and the European Securities Markets Authority ("**ESMA**") have recognized the low-risk profile of NDFs, as compared to other derivatives such as interest rate and credit default swaps, as they both have declined to impose a clearing mandate for NDFs pursuant to the Dodd-Frank Act. The discussion during a meeting of the CFTC's Global Markets Advisory Committee regarding a possible clearing mandate for NDFs noted "the very short date[d] nature of this market."[29] And in response to its consultation on the question, ESMA received comments stating that the average interbank maturity of NDFs is "short, around one or two months," and characterized by "reduced volatility" because "most FX rates on which NDFs trades are based are heavily managed or influenced by Central Bank activity."[30]

As with FX forwards, the risks of derivatives trading identified in the Proposed Rule – that a fund might amass through undue speculation an exposure that, over an extended period of time, imperils its ability to meet its obligations in the regular course of its operations – are not present for NDFs as with other types of derivatives. In failing to account for these fundamental differences in the characteristics of NDFs, as with FX forwards, the Proposed Rule paints with too broad a brush. NDFs, like FX forwards, should be excluded from the definition of a "derivatives transaction" in any final rulemaking.

### C. The Proposed Rule Should Clarify its Exclusion for Purchased Options, and Fails to Appropriately Consider the Distinguishing Characteristics of FX Options

FX options traded on Thomson Reuters' electronic platform are limited-risk instruments. Like the other FX Derivatives discussed herein, they are short-term transactions. Most have maturities less than one month, and virtually all have maturities less than one year. The risk of such instruments can be effectively managed by a fund's advisor without the broad-brush trading limits and regulatory requirements that the Proposed Rule would impose on longer-dated, more highly leveraged, and riskier derivatives instruments.

Indeed, the preamble discussion in the Proposed Rule indicates that the Commission does not intend for purchased options to fall within the definition of a "derivatives transaction." Thomson Reuters agrees, but requests that this be stated clearly and expressly in rule text.

Section 18 of the ICA does not refer to derivatives, but rather to a "senior security." At one point, the preamble discussion explains that the definition of a "derivatives transaction" in the Proposed Rule is "designed to describe those derivatives transactions that in our view involve the issuance of a senior security . . . because they involve a future payment obligation, that is, an

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[29] *See* Transcript, Global Markets Advisory Committee, at 50 (Oct. 9, 2014) (statement of Chris Allen, Barclays), available at http://www.cftc.gov/idc/groups/public/@aboutcftc/documents/file/gmac_100914_transcript.pdf.

[30] *See* Reply form for the Consultation Paper on the Clearing Obligation under EMIR (no. 3), Asociacion de Mercados Financieros, at 8 available at https://www.esma.europa.eu/file/12220/download?token=W-Dx5KYd.

obligation or potential obligation of the fund to make payments or deliver assets to the fund's counterparty."[31]

Elsewhere, the preamble discussion indicates that a purchased option does not involve a future payment obligation; and, therefore, is not a senior security; and, therefore, although it is a derivative, it would not be a "derivatives transaction" as defined in the Proposed Rule. The relevant text is as follows:

> We recognize, however, that not every derivative will involve the issuance of a senior security because not every derivative imposes a future payment obligation on the fund. A fund that purchases an option, for example, generally will make a non-refundable premium payment to obtain the right to acquire (or sell) securities under the option but generally will not have any subsequent obligation to deliver cash or assets to the counterparty unless the fund chooses to exercise the option... [W]e preliminarily believe that a derivative that does not impose a future payment obligation on the fund would not involve a senior security transaction for purposes of section 18 [of the ICA].[32]

We agree with the Commission that a purchased option should not be construed as falling within the definition of a "derivatives transaction" under the Proposed Rule. That conclusion, though, is not necessarily apparent from the text of the proposed definition of the term "derivatives transaction" itself.[33] We urge the Commission to exclude purchased options (including FX options) directly in the rule text itself, rather than addressing the issue through non-contiguous passages in the lengthy preamble discussion.

We also urge the Commission to exclude written "covered calls" from the definition of the term "derivatives transaction" as well. A fund that writes (*i.e.,* sells) a call option receives payment of a premium from the holder (*i.e.,* the purchaser) of the option, and in return must deliver the underlying asset at a pre-agreed price if the holder exercises the option. Such a call option thus would fall within the "derivatives transaction" definition under the Proposed Rule.

If it is a covered call, though, the fund that writes the option owns the security or other asset underlying the option, thereby eliminating its downside risk. Because the delivered asset is in the fund's inventory, the covered call is a riskless financial obligation to the fund. Given that the fund's obligation under the call option is covered by its ownership of the asset to be delivered, writing the option cannot be considered undue speculation, nor does it present the concern that the fund will have to dispose of investments to meet its obligations under the call option as exists

[31] Proposed Rule at 80,899.

[32] *Id.* at 80,891-92.

[33] The text of the proposed definition refers both to options, and also to derivatives instruments under which a fund "may be required to make any payment or delivery of cash or other assets." Any final rule text should be clear that this language does not encompass purchased options.

with respect to highly-leveraged derivatives instruments.[34] Accordingly, since the concerns addressed by the ICA are not present in a covered call, these options should be excluded from the definition of a "derivatives transaction" that is subject to the Proposed Rule.

### D. The Proposed Rule Fails to Appropriately Consider the Risk-Mitigating Purposes for which Funds Use FX Derivatives

The failure of the Proposed Rule to appropriately consider the riskless nature of a covered call option is symptomatic of its broader failure to appropriately consider the risk-mitigating purposes for which funds use FX Derivatives generally. Asset managers rely upon FX Derivatives to mitigate commercial risk associated with their investment strategies, specifically with respect to short-term fluctuations in foreign currency values.[35] More particularly, asset managers trade in FX Derivatives to reduce market risk associated with their regular business activities – primarily in three ways. To illustrate each of these three uses of FX Derivatives to facilitate an asset manager's regular business activities, let's consider a US asset manager that manages a fund looking for market exposure to the global pharmaceutical industry.

1. Use of FX Derivatives to fund the purchase or sale of foreign securities: When a US asset manager purchases Novartis shares on the Swiss Exchange (SIX), it needs Swiss francs to do so. If the stock purchase will settle in three days, the asset manager will buy a 3-day CHF/USD forward to align the arrival and removal of francs in its account. Trading an FX Derivative is less risky than using the spot (cash) FX market because of the T+3 settlement date of the Novartis stock trade. By aligning the settlement dates of the FX Derivative and the foreign security trade, the FX trade carries no market risk.

   Conversely, when the US asset manager sells the Novartis shares, it will receive Swiss francs from the buyer. The US asset manager will sell those francs for dollars, since the dollar is its "base" currency. Again, the use of an FX Derivative enables the asset manager to eliminate market risk by accounting for the T+3 settlement date.

2. Use of FX Derivatives to eliminate the foreign exchange rate risk of the foreign investment: As stated above, the asset manager is looking for exposure to the global pharmaceutical industry, and not to the strength of the Swiss economy against the US economy. And yet, by holding non-US securities in its portfolio, the asset manager is exposed to this global economic risk. By trading an FX Derivatives contract that hedges

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[34] The Proposed Rule notes that many derivatives investments entered into by a fund, including written options, "pose a risk of loss that can result in payment obligations owed to the fund's counterparties." Proposed Rule at 80,891. As noted in text, this is not the case if the written option is a covered call. But the Proposed Rule then continues in accompanying footnote no. 77 that "[s]ome derivatives transactions, like physically settled futures and forwards, can require the fund to deliver the underlying reference assets regardless of whether the fund experiences losses on the transaction." *Id.* at n.77. We do not read footnote no. 77 to be saying that the ICA requires trading limits on transactions that can require a fund to deliver an underlying reference asset even if, like a covered call, the transaction does not put the fund at risk.

[35] In the Determination, Treasury stated that FX forwards and FX swaps 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." Determination at 69,694.

its risk to the rise or fall of the franc against the dollar during the time that it owns the Novartis shares, the asset manager can eliminate that foreign exchange risk.

3. Use of FX Derivatives to repatriate dividends paid in foreign currencies: Novartis will pay dividends in Swiss francs, which the asset manager will trade for US dollars. The asset manager does this for two reasons: i) to convert the dividend payment to the base currency against which its returns are measured, and ii) to eliminate unnecessary foreign exchange risk.

The sweeping definition of "derivatives transaction" in the Proposed Rule fails to appropriately consider the uses for which funds typically trade FX Derivatives – with significant consequences. Subjecting FX Derivatives to the trading limits and restrictions of the Proposed Rule would result in the fund described above: i) not being able to deploy its capital in the global pharmaceutical industry, thereby depriving the fund's investors of an opportunity that the asset manager believes would maximize their returns (and leaving the fund more vulnerable to volatility in US capital markets than its international counterparts); or, potentially, ii) proceeding with the foreign investment, but bearing the risks resulting from its inability to trade risk-mitigating FX Derivatives. In either event, liquidity of the foreign exchange market also would be adversely affected.

And given the limited-risk characteristics of FX Derivatives previously discussed, it is unlikely that the trading limits and restrictions will be triggered by the FX Derivatives that the fund would enter into relating to its investments in Novartis shares. Rather, the fund will be unable to make the foreign investment, or be unable to appropriately manage the risks of that foreign investment, because of its other activities involving non-FX Derivatives that are far more likely to raise the concerns under the ICA that the Proposed Rule seeks to address.

FX Derivatives play a critical role in facilitating access to global markets, and in the case of NDFs to certain emerging markets in particular, for funds and their investors. The Proposed Rule would inappropriately cap or eliminate this important risk-management tool that funds use in making global investment decisions in the course of their regular business activities.[36]

The Proposed Rule declines to consider the purposes for which "derivatives transactions" are used because "it would be difficult to develop a suitably objective standard for [hedging] transactions, and that confirming compliance with any such standard would be difficult, both for fund compliance personnel and for our staff."[37] It continues:

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[36] Because NDFs and FX forwards are economically and functionally indistinguishable, they are used to effect similar transactions, and thus NDFs, like FX forwards, should be excluded from the definition of the term "derivatives transaction." A fund that has a demonstrated need to hedge its FX exposure either by using NDFs or FX forwards, should not be forced to prefer one instrument over another purely on the basis of arbitrarily drawn jurisdictional lines. Nor should it be denied the opportunity to invest in an emerging market because its currency is non-deliverable and NDFs are placed on the "wrong" side of that jurisdictional line.

[37] Proposed Rule at 80,909.

> In addition, many hedges are imperfect, making it difficult to distinguish purported hedges from leveraged or speculative exposures or to provide criteria for this purpose in the proposed rule that would be appropriate for the diversity of funds subject to the proposed rule and the diversity of strategies and derivatives they use or may use in the future.[38]

We respectfully submit that standards to account for the hedging use of FX Derivatives can and should be developed – and that such standards, if incorporated into rule text, also would generally serve to exclude FX Derivatives from the definition of "derivatives transactions." Government regulations that account for hedging activity are common in a variety of contexts.

The Commission itself has set hedging standards before. For example, in further defining the term "major security-based swap participant" pursuant to authority granted under the Dodd-Frank Act, the Commission (jointly with the CFTC) adopted a new rule specifically defining the phrase "hedging or mitigating commercial risk." The rule sets forth a general definition, and then specifically identifies certain security-based swap positions that, "[d]epending on the applicable facts and circumstances . . . may be expected" to fall within that general definition. These include positions established to manage equity or market risk in certain circumstances, bank positions established to manage counterparty risk in connection with loans, and positions established to manage default risk in identified scenarios.[39]

In Europe, the European Market Infrastructure Regulation ("**EMIR**") provides that in calculating whether it is subject to clearing requirements, a non-financial counterparty shall include OTC derivatives contracts "which are not objectively measurable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty." ESMA was specifically directed to develop regulatory technical standards specifying criteria for establishing which OTC derivatives contracts satisfy that standard.[40] It did so in Commission Delegated Regulation 149/2013, where it concluded that a derivative contract "shall be objectively measurable as reducing risks" if, among other things, it: i) "covers risks arising from the potential indirect impact on the value of assets . . . resulting from fluctuation of interest rates, inflation rates, foreign exchange rates or credit risk;" or ii) qualifies as a hedging contract pursuant to certain financial reporting standards adopted in the EU.[41]

The CFTC's rule governing when a non-financial entity may elect the end-user exception from mandatory clearing of interest rate and credit default swaps includes a requirement that the swap

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[38] *Id.*

[39] *See* rule 3a67-4 under the Exchange Act; *see also Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant,"* 77 Fed. Reg. 30,596 (May 23, 2012).

[40] Regulation (EU) No 648/2012 of the European Parliament and of the Council, *OTC Derivatives, Central Counterparties and Trade Repositories*, Article 10 (July 4, 2012), available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32012R0648.

[41] Commission Delegated Regulation (EU) No 149/2013, Chapter VII, Article 10 (Dec. 19, 2012), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0011:0024:EN:PDF.

be used to hedge or mitigate commercial risk. It further provides that a swap meets that standard if it is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, where the risks arise from [among other things] [a]ny fluctuation in interest, currency, or foreign exchange rate exposures arising from a person's current or anticipated assets or liabilities."[42]

We appreciate that bright-line percentages can provide an attractive administrative convenience, particularly with limited agency resources. However, Thomson Reuters respectfully submits that if the Commission, ESMA, the CFTC, and market participants are able to apply hedging standards to determine whether a market participant is a major security-based swap participant, or is subject to a clearing obligation in Europe, or is eligible for the end-user clearing exception in the US, then hedging standards can be developed and applied to establish that FX Derivatives need not be subject to the trading limits and requirements of the Proposed Rule. Before sweeping FX Derivatives into one-size-fits-all trading limitations and regulatory requirements, it is incumbent upon the Commission to determine whether the purposes for which funds enter into such transactions require such treatment.

## III. Conclusion

In light of the unique characteristics of FX Derivatives as compared to other types of derivatives instruments, and the purposes for which FX Derivatives are used by funds as described above, FX Derivatives should be excluded from the definition of the term "derivatives transaction" in any final rulemaking in this area.

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[42] Rule 50.50(c)(1)(i)(F) under the CEA. The Commission's proposed end-user clearing exception rule similarly includes a requirement that the security-based swap be used to hedge or mitigate commercial risk, and incorporates the definition of "hedging or mitigating commercial risk" in rule 3a67-4 under the Exchange Act, discussed above. *See* proposed rule 3Cg-1 under the Exchange Act; *see also End-User Exception to Mandatory Clearing of Security-Based Swaps*, Exchange Act Release No. 63556 (Dec. 15, 2010), available at

http://www.sec.gov/rules/proposed/2010/34-63556.pdf.

Thomson Reuters appreciates the opportunity to provide the Commission with its perspective on the foregoing aspects of the Proposed Rule, as well as certain of the questions posed therein. If you have any questions regarding our comments, please contact the undersigned at [redacted] or Wayne Pestone, CCO, TR SEF at [redacted].

Respectfully submitted,

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