



Our last post examined examples of currency hedges that we believe Rule 18f-4(c)(4)(i)(B) should allow a fund seeking to comply with the [Limited Derivatives User](#) requirements to exclude from its derivatives exposure. This post struggles with examples of interest-rate hedges that may, or may not, be excluded.

A Paradigmatic Bond Hedge

As originally proposed, Rule 18f-4 would have excluded only currency hedges. The final rule added the exclusion of interest-rate hedges based on commenters who:

[routinely enter into fixed-to-floating interest rate swaps \(or vice versa\) and \[match\] these transactions ... to the notional amount and maturity of a specific security in the fund's portfolio.](#)"

As the SEC added the exclusion of interest-rate hedges to accommodate these commenters, it is reasonable to conclude that such a fixed-to-floating rate swap could be excluded from a fund's derivatives exposure. We are less sure about the "vice versa," as a floating-to-fixed rate swap would increase, rather than mitigate, a fund's interest-rate risk. We do not believe the SEC would view using derivatives to increase duration as a "[hedging purpose](#)."

A Less Perfect Hedge

The swaps in the commenters' example matched the principal amount and maturity of the hedged investment exactly. What about an interest-rate derivative with a different maturity? For example, could a fund hedge a seven-year fixed-rate corporate note with Treasury futures? Only [five- and ten-year futures](#) are available on the Chicago Board of Trade, so it would not be possible to match the note's maturity. As noted in our previous posts,

the SEC intended to exclude only interest-rate hedges that:

[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.](#)"

Using a five- or ten-year Treasury future to hedge the interest rate risk of a seven-year corporate note will introduce some basis risk. Whether such futures should be excluded from a fund's derivatives exposure appears to depend on whether this risk should be managed as part of a Rule 18f-4 DRM Program. Perhaps a simple policy of using the future with the lowest historical basis risk would adequately address the risk without requiring [the other elements of a DRM Program](#). While we expect that many fund complexes would seek to exclude this common form of interest-rate hedge, we found little support for that position in the rule or its adopting release.

The Option Option

We have previously explained that [an option purchased by a fund is not a "derivatives transaction"](#) under Rule 18f-4 because it does not obligate the fund to make any future payment or delivery. Thus, a fund could hedge its interest rate risk by purchasing put options on Treasury futures without adding to their derivatives exposure. Funds may resort to this expedient if they cannot exclude Treasury futures from their derivatives exposure. We do not know whether options would be a close substitute for the underlying future, but it would be unfortunate if the technical limitations of Rule 18f-4 encouraged funds to use a potentially less efficient means of hedging interest rate risk, particularly if the options might also introduce increased basis risk. Next up, we tackle issues relating to the "10% buffer" permitted for excluding currency and interest rate hedges.

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