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Should Asset Segregation Do Double Duty?

I've been discussing comments on the SEC's [proposed Rule 18f-4](#) in light of the SEC's initial regulation of derivatives in [Release No. IC-10666](#) ("Release 10666"). As explained in my first [post](#), the objectives of the proposed rule include limiting the "speculative character" of funds that use derivatives and assuring they have sufficient assets to cover their obligations. Release 10666 used one means, asset segregation, to achieve both ends. Several comment letters appear to question whether this approach is still tenable. **Asset Segregation under Release 10666** For both firm and standby commitments (that is, futures, forwards and written puts), Release 10666 required segregation of "liquid assets equal in value to the purchase price due on the settlement date." "Liquid assets" included "cash, U.S. government securities or other appropriate high grade debt obligations." A commitment to deliver a security not held by the fund would be a short sale, requiring segregation "equal to the difference between (a) the market value of the securities sold short at the time they were sold short and (b) any cash or U.S. government securities required to be deposited as collateral ... in connection with the short sale" Release No. IC-7221, cited in footnote 15 of Release 10666. **Hitting Both Birds** "Liquid assets" as defined by Release 10666 were low volatility assets—at least as compared to publicly traded stocks. By requiring segregation of the full purchase price or market value of the underlying asset, Release 10666 forced a fund using derivatives to devote part of its portfolio to low volatility assets. The more a fund used derivatives (which might increase its speculative character), the more low volatility assets the fund must hold (which would dampen its speculative character). Insofar as the segregated assets were liquid, the fund could sell them to raise the cash required to pay the purchase price or acquire the asset underlying the derivative. Thus, segregation also created a reserve from which the fund could meet its obligations with respect to derivatives. **Still Trying to Do Double Duty** Proposed Rule 18f-4 would limit a fund's exposure to senior securities transactions. "Senior security transactions" include derivative transactions, financial commitment transactions, traditional borrowings and (for closed-end funds) preferred stock. A fund's exposure to senior security transactions would be limited to either 150% or 300% of its net assets. A fund could exceed the 150% limit only if its use of derivatives reduced its value-at-risk.

[T]hese portfolio limitations are designed primarily to address the undue speculation concern expressed in section 1(b)(7) by imposing an overall limit on the amount of exposure to underlying reference assets, and potential leverage, that a fund would be able to obtain through derivatives and other senior securities transactions.

Rule 18f-4 would also require funds to segregate cash and cash equivalents (defined as "qualifying coverage assets") to cover their derivatives transactions. Qualifying coverage assets for financial commitment transactions would also include any collateral securing the commitment and "assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation" before the obligation comes due.

This requirement is designed to address the asset sufficiency concern reflected in section 1(b)(8) of the Act... [and also] help to address the undue speculation concern reflected in section 1(b)(7)

In other words, asset segregation would continue to do double duty under Rule 18f-4, even though the rule also seeks to limit leverage directly through exposure limits. **Belt or Suspenders** Rule 18f-4's definition of "qualifying coverage assets" would be more restrictive than the current definition of "liquid assets" (assets that may be sold in seven days at their approximate carrying value) or even Release 10666's original definition of "liquid assets." Commenters have identified numerous problems with the proposed segregation requirement, such as difficulties in hedging currency or interest rate risks and operating business development companies. Funds have well-tested means for meeting their financial commitments other than maintaining large piles of cash and cash equivalents. I sense that the restrictive definition of qualifying coverage assets is aimed more at (b)(7) than (b)(8). If the final reform includes direct limitations on how much leverage a fund can generate through

senior security transactions, perhaps it would be best to focus the asset segregation requirement on just maintaining sufficient reserves. This would allow the SEC to adopt a more workable definition of "qualifying coverage assets."

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