Blogs
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Asset Management ADVocate

Re-Proposed Rule 18f-4: Not Reinventing the Derivatives Wheel

Not content with Steve's detour into the relationship between Rule 2a-7 and re-proposed Rule 18f-4, we would also like to point out a set of rules under which the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") have wrestled with the distinctions between "swaps, security-based swaps and security-based swap agreements" and non-derivative transactions. Release No. 33-9938 (the "Release") not only adopted regulations distinguishing swaps from other types of derivatives instruments (such as securities forwards) and securities, but also included interpretive guidance for distinguishing swaps from consumer and commercial agreements, contracts, and transactions. Several of the commercial transactions discussed in this Release correspond to the type of loan commitments the SEC proposes to include in the definition of "unfunded commitment agreement" in Rule 18f?4. We suggest that some factors used to distinguish one type of derivative instrument (a swap) from commercial lending transactions may also help distinguish these transactions from derivatives instruments more generally.

Types of Loans Excluded from the Definition of a Swap

The Release provides several examples of commercial transactions that the SEC and CFTC do not view as swaps or, by implication, other forms of derivative instruments. The examples include the following lending arrangements:

- Fixed or variable interest rate commercial loans or mortgages with embedded interest rate locks, caps, or floors, provided that such embedded interest rate locks, caps, or floors are included for the sole purpose of providing a lock, cap, or floor on the interest rate on such loan or mortgage and do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the interest rate risk being addressed; [and]
- Fixed or variable interest rate commercial loans or mortgages with embedded interest rate options, including such loans or mortgages that contain provisions causing the interest rate to change upon certain events related to the borrower, such as a higher rate of interest following a default, provided that such embedded interest rate options do not include additional provisions that would provide exposure to enhanced or inverse performance, or other risks unrelated to the primary reason the embedded interest rate option is included ….

These strike us as lending arrangements that the SEC should also exclude from the definition of "derivatives transactions" in Rule 18f-4, subject to the same provisos regarding exposure to enhanced or inverse performance and unrelated risks.

General Criteria for Distinguishing Commercial Transactions from Swaps

The interpretive guidance also included "characteristics and factors" the commissions intend to consider when determining whether a transaction is a swap or security-based swap. The criteria for commercial transactions are:

- They do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract, or transaction;
- They are not traded on an organized market or over-the-counter; and
- In the case of commercial arrangements, they are entered into:
    - By commercial or non-profit entities as principals (or by their agents) to serve an independent commercial, business, or non-profit purpose, and
    - Other than for speculative, hedging, or investment purposes.

We suggest that the SEC consider whether any of these criterion should be applied to distinguish unfunded commitment agreements from derivatives transactions under Rule 18f-4. For example, if a loan commitment permitted the lender to assign the right to interest payments separately from the commitment (thus severing or "stripping" the interest payments), this might indicate that the commitment should be treated as a derivatives transaction. The prohibition on trading seems problematic, even in the context of defining a swap. Banks and other lenders routinely trade "fixed or variable interest rate commercial loans." The Release includes an interpretation regarding loan participations which refers to this trading activity. As the SEC has never suggested that such trading activity turns commercial loans into swaps, we would hope the SEC would also agree that trading commitments to make such loans should not make them derivatives transactions. The final criterion, that the transaction is not for "speculative, hedging, or investment purposes," cannot apply in the context of Rule 18f-4, as an investment company should always enter into a loan commitment for investment purposes. Considerations of what makes an investment a swap differ from considerations of when an investment has leveraging effects, so these criteria provide a starting point, rather than an end, for our analysis.

Conclusion

The SEC and CFTC's interpretive guidance on swaps provides some potentially useful criteria for distinguishing commitment agreements from derivative transactions. However, we still need some means of determining when a commitment is unlikely to have "leveraging effects" on the fund's net asset, and we will return to this topic in our subsequent posts.

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