Blogs
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Asset Management ADVocate

Exclusion of Non-Standard Settlements—Something for Every Fund in Rule 18f-4

This post is the second installment of our discussion of the compliance requirements of new Rule 18f-4. The comments on proposed Rule 18f-4 revealed a significant lacuna in the rule resulting from two unrelated changes to current regulations. First, the SEC will rescind Investment Company Act Release No. 10666 ("Release 10666") as of August 19, 2022, the same day funds must comply with Rule 18f-4. Second, money market funds are excluded from the exemptions for derivatives transactions provided by Rule 18f-4. This post will explain why this was a problem and how the final rule addresses it.

Release 10666 and Firm Commitments

Release 10666 was issued in 1979 and set forth the SEC's policies on when certain trading practices would create "senior securities" for purposes of Section 18 of the Investment Company Act of 1940. These trading practices included "**firm commitment agreements**," which Release 10666 defined as:

> a buy order for delayed delivery in which an investment company agrees to purchase a Ginnie Mae [for example] from a seller … at [a] future date, stated price, and fixed yield."

Release 10666 allowed funds to enter into firm commitment agreements provided they segregated "liquid assets equal in value to the purchase price due on the settlement date."

Money Funds and Firm Commitments

Firm commitments frequently arise in connection with the sale of newly issued securities when the issuer requires buyers to agree to purchase the securities before their scheduled date of issuance. For example, on January 26, 2021, the Treasury auctioned 5-year notes it will issue on February 1. Successful bidders in the auction entered into firm commitments having a duration of five days (exclusive of the issuance date). Money market funds frequently enter into firm commitments to purchase Treasury bills at auction. Municipal money market funds also may need to commit to purchase one-year municipal tax and revenue anticipation notes as much as one month ahead of their issuance. This is one reason 397 days (13 months inclusive of a leap year) is the maximum maturity (measured from the trade date) permitted by Rule 2a-7. Money funds rely on Release 10666 to enter into these firm commitments without violating Section 18(f). As liquid assets comprise nearly all of a money fund's portfolio, a fund has more than enough liquid assets to comply with the segregation requirement of the release. Rescinding Release 10666, coupled with excluding money funds from Rule 18f-4, would leave money funds without a safe harbor for these firm commitments.

Non-Standard Settlements that Are Not Senior Securities

The final rule tacks on a new paragraph (f) to solve this problem. This is the only paragraph that applies to money funds in addition to other open-end funds, closed-end funds and business development companies ("**BDCs**") covered by the rest of Rule 18f-4. The new paragraph partly reverses the policy of Release 10666 to provide that a transaction will not be a "senior security" for purposes of Sections 18 and (for BDCs) 61 if:

- The trade settles within 35 days of its trade date; and
- The fund intends to physically settle the trade "rather than to engage in an offsetting transaction."

Compliance Checklist for Delayed-Settlement Securities

- Identify non-regular-way trades (e.g., listed equity trades settling beyond T+2).
- Calculate difference between trade and settlement date.
- If difference is 35 days or less, flag whether intended to be physically settled.
- Establish exception process if changed circumstances prevent physical settlement.
- Test to confirm that flagged trades have been physically settled.

Although not required by the rule, it may be advisable to earmark sufficient cash or other resources to assure physical settlement.

In other words, the fund should accept delivery of the security within 35 days of making its commitment. The adopting release (the "**Release**") refers to transactions that meet these two requirements as "**delayed-settlement securities**." The fund should not sell, offset, roll or otherwise extend a delayed-settlement security, as such offsetting transactions could retroactively cast doubt on the fund's intent when it entered into the commitment. Paragraph (f) does not require funds to segregate liquid assets to cover delayed-settlement securities. Nevertheless:

> Because funds will be required to intend to settle these transactions physically, [the SEC expects that] funds must have sufficient assets to meet that obligation …."

Hence, a delayed-settlement security should not be an "unfunded commitment agreement," for which "a fund must document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its … obligations."

Delayed-Settlement Securities and Derivatives Exposure

We do not believe that delayed-settlement securities should be included in a fund's "derivatives exposure" when determining whether the fund is a limited derivatives user under paragraph (c)(4). The primary reason is that paragraph (f) excludes delayed-settlement securities from "senior securities" altogether, whereas the rest of Rule 18f-4 regulates transactions that the SEC regards as senior securities. Including delayed-settlement securities in derivatives exposure would bring these transactions back into the rest of Rule 18f-4 through a back door. It would also leave the use of delayed-settlement securities by money market funds unrestricted while potentially imposing restrictions on their use by other types of funds, which would be an odd result. We find additional support from the following sentence from the Release:

> Where these firm and standby commitment agreements and similar transactions do not satisfy the conditions in [paragraph (f)], we do not see a basis to differentiate the transactions from other instruments included in the derivatives transactions definition."

A corollary to this statement is that paragraph (f) was intended to "differentiate [delayed-settlement securities] from other instruments included in the derivatives transactions definition." If delayed-settlement securities are excluded from the definition of derivatives transactions, they should also be excluded from the definition of derivatives exposure.

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