

## Financial Transactions Similar to Reverse Repos (and Why they Matter)

This is the fourth installment of our discussion of the compliance requirements of new Rule 18f?4. Our [last post](#) considered the application of [paragraph \(d\)](#) of the new rule to reverse repurchase agreements ("reverse repos") and the compliance alternatives provided to business development companies, closed-end funds and open-end funds other than money market funds (collectively, "Funds"). Paragraph (d) also applies to financing transactions that are similar to reverse repos. This post discusses examples of "similar financing transactions" provided in the adopting release (the "[Release](#)").

### Margin Trading

The similarity of purchasing securities on margin to reverse repo may not be obvious, as reverse repos involve selling rather than purchasing. But pledging securities to obtain a margin loan is similar to selling securities in a reverse repo, in so far as a margin loan and the reverse repo both provide a Fund with cash that can be used to make other investments. In any event, [footnote 728](#) of the Release includes purchasing securities on margin as "similar financing transactions" subject to paragraph (d).

### Inverse Floaters Created by a Fund

According to the Release:

[In a TOB \[tender option bond\] financing, similar to a reverse repurchase agreement, a fund transfers a bond to a TOB trust that, in turn, issues floating rate securities to money market funds and other investors, often called 'floaters,' and transfers to the fund the residual interest in the trust \(an 'inverse floater'\) and the proceeds of the sale of the floating rate securities."](#)

The Fund can use the proceeds from the sale of the floaters to make other investments, just as it could with the purchase price received from a reverse repo. In fact, TOBs were developed as an alternative to reverse repos because [income from a repo is not tax-exempt](#). Some commenters pointed out that some "non-recourse" inverse floaters differ from reverse repos because the Fund does not agree to repurchase the underlying bond or the floaters. The SEC declined to draw a distinction, finding that:

[In both a recourse and non-recourse TOB financing, the fund effectively is engaging in a leveraging transaction .... \[W\]e believe TOB financings involve a borrowing by the fund regardless of whether the holders of the floaters would look to the fund or some other party if the ... proceeds realized upon the bond's sale is insufficient to repay them."](#)

### Securities Lending

The third example of "similar financing transactions" are securities lending transactions, which is the other side of the short-sale borrowings Rule 18f?4 includes in its definition of "derivatives exposure."

Securities lending arrangements are structurally similar to reverse repurchase agreements in that, in both cases, a fund transfers a portfolio security to a counterparty in exchange for cash (or other assets)."

In this instance, the SEC draws a distinction based on the Fund's use of the cash collateral received for the securities loan. If the Fund invests the cash collateral only in cash or cash equivalents, then the securities loan would not be a similar financial transaction. On the other hand:

If a fund were to ... invest the cash collateral in securities other than cash or cash equivalents, this may result in leveraging of the fund's portfolio. Accordingly, ... this activity would be a 'similar financing transaction' ...."

Cash equivalents are defined by reference to generally accepted accounting principles, and "include certain Treasury bills, agency securities, bank deposits, commercial paper, and shares of money market funds."

## **Consistent Treatment of Similar Financing Transactions**

Our previous post described how Funds have the option of either (a) including reverse repos in their Section 18 asset coverage limits or (b) treating reverse repos as derivatives transactions. [A Fund must apply whichever method it chooses to "similar financing transactions" as well](#); it cannot pick and choose on a transactional basis. A Fund must maintain a record of which method it uses and of any change in method. Our next post on paragraph (d) will discuss transactions that Funds must treat as derivatives transactions rather than financing transactions similar to reverse repo.

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