Blogs
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Asset Management ADVocate

Unfunded Commitment Agreements under Rule 18f-4: The Last Vestige of Release 10666

This is the ninth installment of our review of the compliance requirements of new Rule 18f?4. Our last post explained why unfunded commitment agreements present asset sufficiency risk but did not create leverage risk. In this post, we will explain how paragraph (e) of the new rule controls asset sufficiency risk, tracing its origins back to Release No. IC-10666 ("Release 10666").

Asset Segregation

As we have explained before, Release 10666 represents the starting point of the SEC's regulation of derivatives under Section 18 of the Investment Company Act of 1940. Release 10666 required, among other things, a mutual fund to "cover" firm and stand-by commitments by segregating cash, U.S. government securities or other appropriate high-grade debt obligations into a separate account. A subsequent no-action letter allowed any liquid asset to be "segregated." We put "segregated" in quotes because funds typically would "earmark" liquid assets with a market value equal to their commitments rather than moving liquid assets to a separate account at their custodian. The SEC is rescinding Release 10666 and the no-action letter effective August 19, 2022.

Paragraph (e)—Segregation Lite

New Rule 18f-4 "cuts to the chase" in addressing the asset sufficiency risk of unfunded commitment agreement by just requiring a business development company, closed-end fund or open-end fund other than a money market fund (a "Fund") to:

> document the basis for its reasonable belief regarding the sufficiency of its cash and cash equivalents to meet its unfunded commitment agreement obligations"

each time it enters into an unfunded commitment agreement. Essentially, it is sufficient to have a plan to cover the Fund's commitments and to document that plan. The plan

> must take into account [the Fund's] reasonable expectations with respect to other obligations (including any obligation with respect to senior securities or redemptions)."

In other words, the plan must allow for the possibility that the Fund will need cash and cash equivalents to redeem shares or service outstanding indebtedness (like a bank line of credit) or (in the case of a closed-end fund) preferred stock, as well as to meet drawings on its commitments.

Reliable Sources of Funding

The Fund's plan cannot rely on

> cash that may become available from the sale or disposition of any investment at a price that deviates significantly from the market value of those investments, or from issuing additional

> equity."

This implies that the plan can include cash from the sale of liquid portfolio holdings for their current market value. Obviously, cash and cash equivalents on hand could also be included. Proceeds from the sale of equity were excluded because the SEC believes "a fund's future ability to raise cash by issuing equity would depend on a variety of factors, including future market conditions, that are too speculative" to provide a reliable source of funding. The plan may include, however, cash raised through "the issuance of debt (e.g., borrowings from financial institutions, or the issuance of debt securities)." It is not clear to us why a closed-end fund's ability to raise cash by issuing bonds is less speculative than by issuing preferred stock. We also do not understand why a plan may rely on a bank line of credit but not a binding commitment to invest equity in the fund.

How Much Is Sufficient?

When formulating its plan, a Fund

> could consider, for example, its strategy, its assets' liquidity, its borrowing capacity under existing committed lines of credit, and the contractual provisions of its unfunded commitment agreements."

The plan

> also could be informed by a fund's assessment of the likelihood that subsequent market or other events could impair the fund's ability to have sufficient cash."

Finally, a Fund with loan commitments,

> could evaluate the likelihood that different potential borrowers would meet contractual 'milestones' that the borrowers would have to satisfy as a condition to the obligation to fund a loan, as well as the amount of the anticipated borrowing."

This means that a plan need not provide sufficient cash to cover the full amount of the Fund's loan commitments if its "historical experience with comparable obligations" indicates that it is unlikely that all of the commitments will be fully drawn at the same time. Our next post will use the concept of asset sufficiency risk and the need for a reasonable belief that a Fund can meet its commitments to sort out what transactions a Fund should treat as unfunded commitment agreements.

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