Blogs
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Asset Management ADVocate

Identifying Unfunded Commitment Agreements

This is the tenth installment of our review of the compliance requirements of new Rule 18f?4 as it applies to business development companies, closed-end funds and open-end funds other than a money market fund ("Funds"). We have previously discussed the asset sufficiency risk posed by unfunded commitment agreements and the means by which paragraph (e) addresses this risk. This post will use these concepts to develop a working definition of when a firm or stand-by commitment should be treated as an unfunded commitment agreement.

Basic Elements of the Definition

We can break Rule 18f-4's definition of an "unfunded commitment agreement" into these elements:

- A conditional or unconditional commitment,
- to make a loan to a company, or
- to invest equity in a company,
- in the future.

The definition provides as an example a "capital commitment to a private fund that can be drawn at the discretion of the fund's general partner." Initially, we thought that the commitment must be made to the company, rather than to another party. But the literal definition does not specify to whom the commitment must be made and we found nothing in the adopting release (the "Release") to this effect. This suggests a Fund may treat a participation in a loan commitment, in which the Fund agrees with a lender to participate in loans without entering into an agreement with the borrower, as an unfunded commitment agreement.

To-Be-Announced Trades ("TBAs")

It may be tempting to shoehorn purchases of "to-be-announced" mortgage-backed securities ("MBS") into unfunded commitment agreements. A TBA is essentially a commitment to invest in the trust which holds the to-be-announced pool of mortgages in the future. The Release, however, is unequivocal in classifying TBAs as derivatives transactions, which are excluded from the definition of unfunded commitment agreements. We would reconcile the Release's position on TBAs with the definition of unfunded commitment agreement based on the risks involved. TBAs are widely traded in secondary markets and fluctuate in value. Such fluctuations will affect a Fund's net asset value even though the Fund has yet to pay for the MBS, thereby creating leverage risk. We previously explained that unfunded commitment agreements should present only asset sufficiency risk, not leverage risk. TBAs fail this criteria and, thus, should not be treated as unfunded commitment agreements. If our analysis is correct, Funds should remain alert for the development of a secondary market for their commitments. To be clear, the fact that loans or equity investments obtained from a commitment can be traded should not mean the commitment is a derivatives transaction rather than an unfunded commitment agreement. But if a Fund can transfer the commitment ***itself*** at a gain or loss, this should raise questions as to whether it remains an unfunded commitment agreement.

Convertible Securities

Convertible securities arguably commit a Fund to invest in the issuer's equity securities through conversion. If only the Fund has the option to convert, then the convertible security should not be treated as a derivatives transaction or unfunded commitment agreement because the Fund does not have a future obligation. Some securities, on the other hand, are convertible at the option of the issuer; are these unfunded commitment agreements? We would argue convertible securities are never derivative transactions or unfunded commitment agreements because the Fund has already made its investment. Although technically the exercise of an issuer's conversion right would require the Fund to deliver the convertible security in exchange for the issuer's equity, financially the Fund's existing investment is just being shifted to another layer of the issuer's capital structure. As the Fund will necessarily have the convertible security to deliver, there should never be an asset sufficiency risk, so a Fund would automatically comply with paragraph (e) in any event. In these circumstances, we cannot find anything to be gained by treating convertible securities as unfunded commitment agreements. Our next post will close out our discussion of unfunded commitment agreements with a compliance checklist.

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