Compliance Checklist for Unfunded Commitment Agreements

This eleventh 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 money market funds ("Funds") completes our discussion of unfunded commitment agreements. Here we consider what changes may be required for a Fund to comply with paragraph (e) of Rule 18f?4. We suspect this may prove relatively easy for an open-end Fund.

What Is Required

As previously noted, paragraph (e)(2) requires a Fund to "document the basis for its reasonable belief" that the Fund "will have sufficient cash and cash equivalents to meet its obligations" each time it enters into an unfunded commitment agreement. Paragraph (e) does not require the Fund to reevaluate this belief except in the context of whether it can afford to enter into another unfunded commitment agreement. Still, looking at all a fund "could consider" under the heading "How Much Is Sufficient" in our earlier post, documenting the entire "basis" for a reasonable belief seems daunting.

Changing Perspective

When we first discussed "asset sufficiency risk," we noted this was terminology from the adopting release (the "Release"). We now propose a different term: "liquidity risk." Although Rule 22e-4 defines "liquidity risk" in terms of a Fund meeting "requests to redeem shares … without significant dilution," the Fund's unfunded commitments necessarily affect this risk. Rule 22e-4 originally required open-end Funds to account for investments "segregated to cover, or pledged to satisfy margin requirements in connection with, derivatives transactions" when classifying the liquidity of its assets. The Release amends Rule 22e-4 to omit "segregated to cover" because Rule 18f-4 does not require segregation. But we do not think this change means an open-end Fund's liquidity risk management program ("LRM Program") should ignore unfunded commitment agreements. The LRM Program must still account for "short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions," and projected cash out-flows should include draws on unfunded commitment agreements.

LRM Program Modifications

As an open-end Fund amends its LRM Program to delete "segregated to cover," it should consider the following additional modifications to comply with Rule 18f-4(e).

1. Enter and track unfunded commitment agreements, including
    - The committed amount,
    - When draw requests are received and when payments are due,
    - The unfunded balance after each draw, and
    - When the commitment expires.

2. Account for pending and projected drawings in projected cash flows and calculations of cash balances required to cover potential redemptions.
3. Include potential draws on commitments when assessing foreseeable stressed conditions.
4. Create a report or electronic record when a commitment is entered, documenting that the Fund should be able to meet its obligations in compliance with the LRM Program. (E.g., that the sale of highly liquid investments at their current market value to fund projected draws under outstanding commitments should not cause the Fund to fall below its highly liquid investments minimum.)

With these changes, the efficacy of the Fund's LRM Program could provide the basis for its reasonable belief that it will have sufficient cash to meet its obligations. The report or record in #4 would document that each unfunded commitment agreement was included in the LRM Program and evaluated when the Fund entered into the commitment. In our forthcoming posts, we will shift our focus to the core of Rule 18f-4, beginning with a discussion of the foundational elements of paragraph (c).

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