Blogs
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Asset Management ADVocate

Derivatives that Are Not “Derivatives Transactions” under Rule 18f-4

In this, the twelfth installment of our review of the compliance requirements of new Rule 18f?4, we leave the peripheral transactions addressed in the rule (i.e., delayed-delivery transactions, reverse repurchase agreements, and unfunded commitment agreements) and plunge into the core of the rule: "derivatives transactions" regulated by paragraph (c). To prepare for this, we need to understand some core concepts, including "derivatives transactions," "derivatives risks" and "value-at-risk testing." We begin by seeking a bright line for separating investments not subject to Rule 18f-4 from those that may be. We find that whether a Fund has a future payment (or delivery) obligation is what matters the most when determining whether a particular transaction will be regulated as a derivatives transaction under Rule 18f-4.

Options

The definition of "derivatives transaction" includes "any … option." But what this means is that it includes any option a fund writes. In other words, a transaction in which a fund gives the other party the option to require the fund to purchase or sell the underlying asset. When the fund may exercise the option, the option typically will not be a derivatives transaction. As the SEC explains in the adopting release (the "Release"):

> the definition [of "derivatives transaction"] also provides that a derivatives instrument, for purposes of the rule, **must involve a future payment obligation**. This aspect of the definition recognizes that not every derivatives instrument imposes such an obligation, and therefore not every derivatives instrument will involve the issuance of a senior security. … A derivative that does not impose any future payment obligation on a fund generally resembles a securities investment that is not a senior security, in that it may lose value but it will not require the fund to make any payments in the future."

Hence, if a fund pays an upfront premium for an option and does not have to exercise it, the option is not a derivatives transaction.

Swaps?

A commenter on the proposed rule tried to extend this approach to swaps. (See footnote 88) The commenter reached too far, however, by arguing that any margin a fund posted for a swap would fully cover its obligation in the event of a close-out. The SEC rejected this comment because the fund would be subject to calls for additional margin and, thus, incur a future payment obligation. Although most swaps involve the exchange of periodic payments between the parties, some swaps require only a single initial payment from one of the parties. For example, a purchaser of credit protection under a credit default swap ("CDS") may pay a single premium to the other party. A CDS is essentially a conditional option; the obligation to acquire the referenced obligation arises only following a credit event with respect to such obligation. If a fund purchases (rather than sells) credit protection for a single premium, with no future payment obligation, the CDS should be treated like an option and be excluded from the fund's derivatives transactions for purposes of Rule 18f-4. "The label that a fund or its counterparty assigns to the transaction is not determinative."

Structured Investment Products

We previously explained why certain "inverse floaters" are excluded from Rule 18f-4 because they are not senior securities of a fund. We can make the same point more generally, and draw an important distinction, using the touchstone of whether the fund has a future payment obligation. Typically, a structured investment product, such as a collateralize mortgage obligation, asset-backed security or exchange-traded note ("ETN"), does not impose payment obligations on a fund after the purchase. The absence of a future payment obligation should preclude these products from being included in a fund's derivatives transactions. On the other hand, in the rare instance where a structured investment product provides for recourse to a fund, this would create a future payment obligation that requires the fund to treat it as a derivatives transaction. We are less certain about a feature of some ETNs in which a fund forfeits its right to receive interest if the referenced asset, rate or index exceeds or falls below a specified threshold. If the fund has accrued the interest, this would have the same financial consequence as a future payment. However, such ETNs never entail asset sufficiency (liquidity) risk and, depending on the structure, may not create leverage risk, which are the targets of Rule 18f-4.

Conclusion

Having established the absence of future payment obligations as a basis for excluding investments from Rule 18f-4, our next post will examine some low-risk transactions that are nevertheless subject to the rule.

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