Blogs
March 29, 2021
Asset Management ADVocate

Rule 18f-4 Derivatives Transactions Recap

This post completes our exploration of the definition of "derivatives transactions" in Rule 18f-4, which is relevant to business development companies, closed-end funds and open-end funds other than a money market fund ("Funds"). Our object is to generate a fairly comprehensive list of what is, is not, and may be a "derivatives transaction" by using our touchstone of a "future payment obligation" in combination with the literal definition in the rule and points made in earlier posts.

Summary of Transactions

The following table summarizes our conclusions as to the scope of the definition of "derivatives transactions" and provides links to the most relevant post.

Not Derivatives Transactions	May Be Derivatives Transactions	Derivatives Transactions
Non-standard settlement trade Unfunded commitment agreement Purchased option Prepaid swap Non-recourse structured investment product	Reverse Repurchase Agreement or Similar Transaction	"Derivatives Instrument" under which the Fund is obligated to make a future payment or delivery, including a: • periodic-payment swap or security-based swap, • futures contract, • forward contract, • written option, • firm or stand-by commitment that is not an unfunded commitment agreement (e.g., a to-be-announced ("TBA") trade, and any combination thereof. Short-sale borrowing

The most common type of prepaid swap is an interest rate derivative in which the fixed rate payer makes a single payment at the inception of the contract equal to the present value of the future fixed leg payments under the swap. Although it was not discussed in the adopting release, we think the absence of a future payment obligation should exclude a prepaid swap from the definition. As explained at the linked post, Funds have the option either to treat reverse repurchase agreements and similar transactions as derivatives transaction or to include them as senior securities when calculating their asset coverage. Hence the "may be." A non-recourse inverse floater purchased in a tender option bond offering must be treated as similar to a reverse repurchase agreement rather than as a structured investment product. All other transactions

> under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise"

are normally derivatives transactions. This is the case regardless of whether the Fund already holds the cash or assets to be delivered (e.g., covered calls) or has entered into an offsetting transaction (e.g., an option spread). Offsetting transactions are relevant to a Fund's "derivatives exposure," however, which we will discuss in a later post. Our next post moves on from derivatives transactions to derivatives risks.

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