Blogs
December 26, 2019
Asset Management ADVocate

Reproposed Rule 18f-4—Asset Desegregation

In my initial post on the SEC's reproposed rules for regulating the use of derivatives by investment companies ("funds"), I noted favorably that the regulations would extend beyond funds to registered broker/dealers and investment advisers. I think this reflects a more comprehensive, less piecemeal, approach to these proposed rules. I also appreciate the coordination of the Divisions of Investment Management and Trading and Markets in drafting the proposed rules. There are other praiseworthy aspects of the general approach taken in developing the revised proposals. Chief among these is the SEC's willingness to take a fresh look at the means of regulating the risks of derivatives usage. Historically, the SEC's principal means for regulating these risks was to require funds to "segregate" liquid assets to cover a fund's potential obligations for derivative transactions. The revised proposals would eliminate asset segregation in favor of more direct limits on potential volatility resulting from derivative transactions. Risks posed by payment or delivery obligations would represent just one, no longer paramount, component of a comprehensive risk management program.

Good-Bye to All That (Release 10666)

When Rule 18f-4 was first proposed in 2015, I questioned whether too much was being asked of asset segregation. In a nutshell, Section 18 of the Investment Company Act of 1940 (the "1940 Act") was intended to prevent investment companies from (1) using "excessive borrowing and the issuance of excessive amounts of senior securities [to] increase unduly the speculative character of their [common shares]" and (2) "operat[ing] without adequate assets or reserves." I suggested that requiring asset segregation was a better means of addressing the second problem than the first and, therefore, the SEC should consider more direct means of limiting the speculative character of fund shares. The revised proposal would go well beyond this by rescinding the interpretive release (Release No. IC-10666) that required asset segregation and replacing it with general risk management requirements.

Vestiges of Asset Segregation

Traces of the asset segregation requirement can be found in the proposed treatment of unfunded commitment agreements. Rule 18f-4 would define an "unfunded commitment agreement" as:

> a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company or to invest equity in a company in the future …."

(We will leave for another post whether commitments can be divided cleanly from derivatives.) This form of commitment is particularly important to business development companies ("BDCs"), which may issue senior securities only in accordance with the asset coverage limitations and other requirements of Section 61 of the 1940 Act. SEC research shows that BDCs use derivatives only to a limited degree, if at all, in part because a BCD's portfolio must consist primarily of eligible portfolio companies and related investments. Proposed Rule 18f-4(e)(1) would treat an unfunded commitment agreement as a senior security unless the fund:

> reasonably believes, at the time it enters into such agreement, that it *will have* sufficient cash and cash equivalents to meet its obligations with respect to all of its unfunded commitment agreements,

> in each case as they come due."

We have emphasized "will have" because the rule would not require the fund to reserve sufficient cash and cash equivalents at the time it makes the commitment. A fund may anticipate generating the required cash when the commitment comes due, by, for example, selling portfolio securities or drawing on lines of credit. The fund's belief may not be based, however, on expectations that it could raise cash by issuing additional equity or selling investments in the future for significantly more than their current market value. Thus, the revised proposal would replace the requirement to set aside liquid assets at the time of the commitment with a reasonable belief that the fund will have sufficient cash to cover the commitment when, if ever, it becomes due.

Asset Coverage for Derivatives

The requirement for derivative transactions is even more general. The definition of "derivatives risks" includes "liquidity risk," which encompasses:

> risk involving the liquidity demands that derivatives can create to make payments of margin, collateral, or settlement payments to counterparties."

Rule 18f-4 would require all funds that engage in derivatives transactions to have policies and procedures to manage the fund's derivatives risks. The risk management program of funds engaged in more than a limited amount of derivative transactions (generally a fund that uses derivatives for purposes other than hedging foreign exchange risk and does not limit the notional amount of derivative transactions to 10% of its net assets) must include, among other elements, quantitative guidelines, stress- and back-testing, and escalation procedures. Regardless of the extent of derivatives transactions in which a fund engages, liquidity risk is only one of many enumerated risks (such as "leverage, market, counterparty, …, operational, and legal risks") to be identified and managed. The propose rule would not prescribe any particular means of managing liquidity risk, so asset segregation would not be required. I expect most comment letters on the new proposal will support this less prescriptive approach to risk management. I will consider in later posts whether the revised proposal has an effective means of preventing undue speculation.

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