Does Re-Proposed Rule 18f-4 Have Commitment Issues?

My initial posts on re-proposed Rule 18f-4 reflect my generally favorable reactions to the SEC's attempt to develop a practical, hence imperfect, means of implementing the limitations on senior securities required by Section 18 of the Investment Company Act of 1940. My initial series of post written at the time Rule 18f-4 was first proposed attempted to explain some of the inherent difficulties of this task. I will now turn to a more problematic matter: the proposed treatment of so-called "unfunded commitment agreements." While I basically agree with the proposed approach of limiting commitments by requiring a reasonable means of meeting the fund's obligations, I have reservations about how and why the rule proposes to implement this approach.

Proposed Definition of an Unfunded Commitment Agreement

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, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."

As I've emphasized in the quotation, unfunded commitments and derivative transactions are defined as mutually exclusive categories. Rule 18f-4's proposed definition of "*derivatives transaction*" lists a number of "derivatives instruments," but the core of the definition is:

> any similar instrument 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 …."

If we substitute this definition of "derivatives transaction" for those words in the definition of unfunded commitment agreement, and then paraphrase, an unfunded commitment agreement is "a contract under which a fund commits to make a loan to or investment in a company," but under which the fund is not "required to make any payment." How would this be possible?

Commitments Can Be Derivatives

One might try to avoid this apparent contradiction by contending that an unfunded commitment is not "similar to" any of the instruments specified in the definition of derivatives transaction. The proposing release expressly states, however, that some commitments can be derivatives transactions:

> While this proposal does not specifically list firm or standby commitment agreements in the definition of "derivatives transaction," we interpret the definitional phrase "or any similar instrument" to include these agreements. … To the extent that a fund engages in transactions similar to firm or standby commitment agreements, they may fall within the "any similar instrument" definitional language, depending on the facts and circumstances."

I discussed the origin of the terms "firm" and "standby commitment" in an earlier post. A contract to make a loan

or investment on a date certain (a "closing") would be a firm commitment; a commitment to make a loan or investment at the request of the company (a "draw" or "capital call") would be a standby commitment. Thus, it is still hard to discern how an unfunded commitment would not also be a derivatives transaction as defined by proposed Rule 18f-4.

But It's "Unfunded"

It might also be tempting to argue that an "unfunded" commitment is somehow different from a firm or standby commitment. But "unfunded" simply refers to the amount of a commitment that has yet to be performed. If a fund makes a standby commitment to loan or invest $100 million, and subsequently pays $50 million to the company, half of the commitment will have been "funded," leaving the remainder "unfunded." But the unfunded portion is still a standby commitment.

Next Question

If I am correct that there may be a flaw in the definition of "unfunded commitment agreement" (and perhaps no need for the "unfunded"), the next question is how to better distinguish between commitments that should be limited by the risk they add to the portfolio (as measured by VaR) and commitments for which an attenuated version of asset segregation should be a sufficient limitation. This requires a clearer picture of the reasons for this distinction, which I will address in subsequent posts.

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