

Re-Proposed Rule 18f-4: Commitment Agreements—Putting it all Together

This post ends our series critiquing the proposed definition of "[unfunded commitment agreement](#)" in re-proposed [Rule 18f-4](#). This definition is important because it would create an exception from the Value at Risk ("VaR") limitations the proposed rule would impose on "[derivatives transactions](#)" by investment companies. This post will recap the problems with the proposed definition and the approach we would recommend for addressing these shortcomings.

Problem: Failure to Identify Unique Features of Commitment Agreements

The proposing release offered [three reasons](#) for distinguishing commitment agreements from derivatives transactions. The first, "that a fund often does not expect to lend or invest up to the full amount committed," is backward; [a commitment is more likely to be funded than many derivatives transactions](#). The second, "a fund's obligation to lend is commonly subject to conditions," is not unique; many derivatives transactions have conditions to performance. The third, a commitment "do[es] not present an opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment," is true of some commitments but not others. The breadth of the proposed definition would include [commitments that may present opportunities for gain or loss](#).

Solution: Compare Features of Commitment Agreements and Derivatives Transactions and Assess their Leveraging Effects

The Divisions of Investment Management and of Economic and Risk Analysis should identify several transactions they expect to be treated as "derivatives transactions" and others they expect to be treated as "unfunded commitment agreements." The Divisions might use the [commercial transactions that the SEC excluded from the definition of "swaps"](#) as examples of commitments it should also exclude from derivatives transactions. They should then compare the features of the two sets of transactions and identify their unique features. Finally, they should assess the potential leveraging effect of each unique feature. Our post on [morphology](#) illustrated this approach. There are two significant features we think warrant further consideration. First, if the fund does not receive an up-front premium for the commitment and the commitment can be terminated without penalty, the commitment should not present an opportunity for gains and losses. Second, if the fund must post margin to secure its commitment, the commitment is likely to present such opportunities.

Put the Exception in the Right Definition

The proposed [definition of "derivatives transactions"](#) is so broad as to encompass everything in the proposed [definition of "unfunded commitment agreement"](#). To address this, we recommend (a) the SEC carefully define the commitments it intends to exclude from VaR requirements and (b) exclude these commitments from the definition of derivatives transactions rather than excluding derivatives transactions from the definition of unfunded commitment agreements.

Participations

The proposed definition would apply to commitments "to a company." It is not clear whether a fund's commitment to participate in loans made by a lender, without any contract between the fund and the borrower, would qualify. We recommend that the definition of unfunded commitment agreements include [participations which represent an ownership interest](#) in the underlying commitment, as described in the SEC's interpretation of "swaps."

Money Market Funds

[Rule 2a-7](#) already regulates the potential risks presented by derivatives transactions and unfunded commitment agreements engaged in by money market funds. Therefore, rather than excluding money market funds from Rule 18f-4, we recommend providing that a money market fund that acquires a derivatives transaction or unfunded commitment agreement in compliance with Rule 2a-7 will be deemed to comply with Rule 18f-4. Paragraph (d)(3)(v) of Rule 2a-7 would be precedent for this approach.

Drop "Unfunded"

Once a commitment is performed, it is no longer a "commitment." Hence, a commitment to lend or invest money ends when the loan or investment is made. In other words, all such commitments are "unfunded," and the term is redundant.

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