Blogs
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Asset Management ADVocate

Checklist for Including Reverse Repos and Similar Financing Transactions in Asset Coverage Procedures

This is the sixth installment of our discussion of the compliance requirements of new Rule 18f?4 and wraps up our discussion of paragraph (d) of the new rule and its application to business development companies ("**BDCs**"), closed-end funds and open-end funds other than money market funds (collectively, "**Funds**"). This posts identifies which Funds need to update their asset coverage procedures for compliance with Section 18 of the Investment Company Act of 1940 and what those updates should entail.

Which Funds Need Updated Asset Coverage Procedures

As explained in our first post on paragraph (d), Funds have the option to either (a) include reverse repos and similar financing transactions when calculating their asset coverage under Sections 18 or 61, or (b) treat these as derivatives transactions under Rule 18f?4. A Fund must document which method it elects to use. We anticipate that a Fund seeking to qualify as a limited derivatives user should choose the first option, since the 10% limit on derivatives exposure would be more restrictive than the required asset coverage. By contrast, Funds that have a derivatives risk management program (i.e., Funds other than limited derivatives users) should find that their Value-at-Risk model already captures any leveraging effects produced by reverse repos and similar financing transactions. Thus, only a Fund that chooses the first method will need to modify its asset coverage procedures. Funds with derivatives risk management programs will need to address reverse repos and similar financing transaction in their guidelines and other elements of the program, which are beyond the scope of this post.

Checklist for Open- and Closed-End Funds

The following checklist identifies elements that a Fund should add to its existing asset coverage procedures. As the asset coverage required for a BDC varies based on various circumstances, we have limited our checklist to the requirements for open- and closed-end Funds.

1. Review various financing transactions a Fund may enter into and identify those that could leverage the Fund's investment returns similar to reverse repos (collectively, "**18f-4(d) Transactions**"). 18f-4(d) Transactions should include, among other transactions, margin purchases, investments of cash collateral from securities loans in non-cash equivalents and tender-option bond ("**TOB**") financings. 18f-4(d) Transactions should not include, among other transactions, derivatives instruments, to-be-announced purchases of mortgage-backed securities (known as **TBAs**), dollar rolls or collateralized mortgage obligations (known as **CMOs**) and other third-party structured financial products.
2. Tag 18f-4(d) Transactions as they are executed and include the amounts owed in the senior securities representing indebtedness when calculating the Fund's asset coverage. In the case of a TOB financing, this is the amount of the floaters issued and outstanding in the financing.
3. Document that execution of an 18f-4(d) Transaction resulted in asset coverage of at least 300%.
4. Monitor the Fund's asset coverage and:

a. If the asset coverage for an open-end Fund falls below 300%, reduce the 18f-4(d) Transactions or other borrowings to restore asset coverage to 300% within three business-days; or

b. In the case of a closed-end Fund, its asset coverage procedures should already prohibit (i) declaring a non-stock dividend or distribution on the Fund's common stock, or repurchasing stock, when it would result in asset coverage below 300%, or (ii) issuing preferred stock or declaring a non-stock dividend thereon when it would result in asset coverage below 200%.

Having finished with paragraphs (d) and (f), we next move to paragraph (c) of Rule 18f-4 and unfunded commitment agreements.

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