Blogs
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Re-Proposed Rule 18f-4: How Not to Distinguish Commitments from Derivatives

This post continues my assessment of the proposed treatment of unfunded commitments under re-proposed Rule 18f-4. My previous post questioned whether the proposed definition of an "unfunded commitment agreement" successfully carved these transactions out of the definition of "derivatives transactions." This post begins my evaluation of why such a carve out may be warranted. The SEC's release cites three factors offered by commenters that the SEC agreed "distinguish unfunded commitment agreements from … derivatives transactions." Unfortunately, the first two of these factors do not provide a sound basis for drawing such a distinction.

First Factor: Expectations

> First, commenters stated that a fund often does not expect to lend or invest up to the full amount committed."

This is true of every cash-settled future, option or swap, as well as many derivative contracts that purport to require delivery of the underlying asset. If I buy a lean hog future on the CME, I don't necessarily expect to pay (nor does the counterparty expect to deliver) the full purchase price and take delivery of 20 tons of pork. I only expect to pay or receive the difference in the value of the contract at the time I close it out. In fact, an unfunded commitment is more likely to be fully drawn than a derivatives transaction. If a company enters into a future or option for hedging purposes, it can realize the benefit of the contract by closing out for its market value. If an investment company is on the other side of the future or option, it also has the power to close out the contract without making the full payment or delivery. In contrast, a company that pays commitment fees for a loan facility will realize a benefit only by drawing on the facility. The company controls the amount drawn; the investment company cannot prevent the company from drawing the full amount or effectively terminate its commitment by entering into an offsetting contract. This is probably why the proposed rule would require "sufficient cash and cash equivalents to meet [a fund's] obligations with respect to **all** of its unfunded commitment agreements," not just those commitments the fund expects to be drawn.

Second Factor: Conditions

> Second, commenters stated that a fund's obligation to lend is commonly subject to conditions, such as a borrower's obligation to meet certain financial metrics and performance benchmarks, which are not typically present under the types of agreements that the Commission described in Release 10666."

There are several problems with this comment. First, there are derivatives instruments which include conditions. A prime example would be a credit default swap, which may be exercised only upon the occurrence of a credit event. A credit default swap can be characterized as a conditional put option. Unfunded commitments could be distinguished from credit default swaps because, in the latter case, the conditions would require the fund to incur a loss, whereas the conditions for a loan commitment are intended to limit the risk of loss. But other types of puts intended to provide liquidity rather than credit protection have conditions similar to unfunded commitments. An example would be the demand feature for a tender option bond, which terminates upon the occurrence of conditions (such as downgrading of the underlying bond) similar to the conditions that would prevent a company from drawing on a loan commitment. Finally, this factor is inconsistent with the proposed definition of "unfunded commitment agreement," which includes contracts "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."

A Digression

Before moving on to the final reason given for distinguishing unfunded commitments (that they "do not have a leveraging effect"), my next blog will consider the current regulation of commitments made by money market funds. This may give us a clearer view of what a "leveraging effect" means.

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