Blogs
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Asset Management ADVocate

Re-Proposed Rule 18f-4: Why Some Commitment Agreements may not have "Leveraging Effects"

Having completed our detour into regulations and interpretations other than re-proposed Rule 18f-4, this post returns to considering possible justifications for carving out "unfunded commitment agreements" from the proposed Value at Risk limitations of Rule 18f-4. We have previously explained why the first two justification identified in the proposing release are ill-founded, which leaves only the following argument for a carveout:

> Commenters also asserted that unfunded commitment agreements do not give rise to the risks that Release 10666 identified and do not have a leveraging effect on the fund's portfolio because they do not present an opportunity for the fund to realize gains or losses between the date of the fund's commitment and its subsequent investment when the other party to the agreement calls the commitment."

We believe this is true of some, but not all, commitments. To explain why, we begin with the most important element of the proposed definition of "unfunded commitment agreement:" that it is a commitment to *the company* receiving the loan or other investment.

Leveraging Effects of Equity Puts

If a mutual fund writes a put option for stock, it becomes obligated to purchase the specified shares at the specified strike price upon exercise by the option holder. Significantly, upon exercise the holder will deliver outstanding (rather than newly issued) shares: exercising the option transfers the position held by the option holder to the fund without affecting other stockholders. The issuer of the stock does not receive the strike price. Recall our definition of "indebtedness leverage" as "an obligation … [that] enable[s] the fund to participate in gains and losses on an amount that exceeds its initial investment." The put would have a leveraging effect because purchasing the stock for more than its current market value would transfer a loss from the option holder to the fund, which loss may exceed any initial margin (initial investment) provided by the fund.

Equity Commitments to the Issuer—Puts(?) without Leverage

If a mutual fund commits to invest in a company's equity, when the company draws on the commitment the fund receives newly issued, rather than already outstanding, interests. The fund's equity interest will include a proportionate interest in the amount invested. Under the right circumstances, these differences can negate the potential leveraging effects of what is, technically, a put option held by the company. To understand this, consider a commitment by a mutual fund to invest in a limited partnership. Assume the commitment is to provide 5% of the partnership's capital (exclusive of carried interest) up to $5 million, and the fund makes an initial investment of $1 million. As the other partners must also fund a proportionate share of their commitments, this would give the partnership an initial capital of $20 million. When the partnership makes a capital call for an additional $20 million, the fund will need to invest another $1 million. But, unlike the stock option, this investment does not change the fund's share of the partnership's equity. The fund held a 5% interest in the partnership's profits and losses both before and after investing the additional $1 million—the partnership's exercise of the commitment did not alter the fund's "participation in profits and losses." Indeed, "put" may not be an appropriate term for this commitment, as the fund will not receive any additional interest in exchange for the $1 million. This commitment also differs from a put in that it will not transfer existing losses to the fund. Even if the partnership frittered away the initial $20 million, the value of the fund's partnership interest after the next round of investment should equal at least the $1 million invested in that round, as the fund will have a 5% interest in the $20 million of additional capital raised. Whether the fund loses this $1 million as well will depend on the performance of the partnership—not the exercise of the commitment itself.

Conclusion

Footnotes to the Release indicate that Private Equity Growth Capital Council made an argument similar to this in its comments on the original Rule 18f-4 proposal. This is a very limited case, however. We will see in our next post that commitments to make loans might still have leveraging effects.

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