Blogs
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Asset Management ADVocate

Reverse Repos and Rule 18f-4—The Easy and the Hard Ways

This post is the third installment of our discussion of the compliance requirements of new Rule 18f?4. From this point forward, we will be dealing with exemptions that apply only to business development companies ("**BDCs**"), closed-end funds and open-end funds other than money market funds (collectively, "**Funds**"). We first consider paragraph (d) of Rule 18f?4, relating to reverse repurchase agreements ("**reverse repos**").

What is a Reverse Repo

Fund managers have such low self-esteem that they refer to repurchase agreements from the perspective of the securities dealer, the other party to the agreement. When a securities dealer uses the term "repurchase agreement" or "repo," this refers to an agreement in which the dealer sells securities to the Fund for slightly less than their current market value and simultaneously agrees to *repurchase* the securities from the Fund at a slightly higher price (still typically below market value). The combined transactions have the effect of a collateralized loan of the purchase price from the Fund to the dealer, for which the dealer compensates the Fund by paying the higher repurchase price. What dealers call a reverse repo is the opposite arrangement, in which the dealer buys securities from the Fund and simultaneously agrees to resell them to the Fund for a higher price. Fund managers and Rule 18f?4 also call this a reverse repo, even though it is the Fund that *repurchases* the securities.

Reverse Repos, Section 18 & Release 10666

Section 18 of the Investment Company Act of 1940 regulates the issuance of "senior securities" by open- and closed-end investment companies. Section 61 incorporates Section 18 by reference for BDCs. Section 18(g) defines "**senior security**" to include "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness." Section 18 allows Funds other than BDCs to incur such indebtedness provided they maintain "asset coverage" of at least 300%. BDCs have lower (starting at 200%) but more complicated asset coverage requirements that we will not get into. Section 18(h) defines "**asset coverage**" in this context as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness." Open-end funds may incur indebtedness only through bank borrowings, and closed-end funds may have only one class of securities representing indebtedness. Investment Company Act Release No. 10666 ("**Release 10666**") held that reverse repos should be treated as senior securities, but relaxed the requirements of Section 18 in several respects. First, Release 10666 permitted Funds to engage in reverse repos so long as they segregated liquid assets equal to the repurchase price. In theory, this would reduce the asset coverage requirement to 200% if a Fund's portfolio consisted entirely of liquid assets. Second, it permitted open-end funds to engage in reverse repos with securities dealers and other non-bank counterparties. Third, it permitted a closed-end fund to engage in reverse repo even if it had another class of debt outstanding.

Reverse Repos under Rule 18f?4

Rule 18f?4 replaces Release 10666, which will be rescinded on August 19, 2022. Paragraph (d) will continue to treat reverse repos as "senior securities." The adopting release explains that:

> Reverse repurchase agreements … achieve effectively identical results to a bank borrowing or other borrowing. Accordingly, we believe it is appropriate to allow funds to engage in these transactions to the same degree as borrowings under [Section 18], and to treat them equally."

The second sentence indicates how Rule 18f?4(d) departs from Release 10666: Funds will no longer be required to segregate liquid assets equal to the repurchase price. Instead, Funds must

> combin[e] the aggregate amount of indebtedness associated with all reverse repurchase agreements … with the aggregate amount of any other senior securities representing indebtedness when calculating the asset coverage ratio."

The resulting asset coverage ratio still must be at least 300% (or lower for BDCs). Paragraph (d) also gives Funds the alternative of treating reverse repos as derivatives transactions for all purposes of Rule 18f?4. This alternative might be advantageous for a Fund already subject to the Value-at-Risk ("**VaR**") limitations of Rule 18f?4 as it would allow the Fund to engage in reverse repos with less than 300% asset coverage. It should not benefit a limited derivatives user, as the 10% limit on derivatives exposure (which would include reverse repos) would be more restrictive than the 300% asset coverage requirement. Because of the greater difficulty of complying with VaR limits and implementing a risk management program, we consider treating reverse repos as derivatives transactions the harder alternative. Our next post considers what types of "similar financing transactions" may be subject to paragraph (d).

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