

Transactions Not Similar to Reverse Repos under Rule 18f-4(d)

This is the fifth installment of our discussion of the compliance requirements of new Rule 18f-4 and completes our consideration of [paragraph \(d\)](#) of the new rule and its application to business development companies, closed-end funds and open-end funds other than money market funds ("**Funds**"). Our two previous posts considered the application of that paragraph to reverse repurchase agreements ("**reverse repos**") and "similar financing transactions." This post identifies transactions that the adopting release (the "[Release](#)") indicates would not be similar to reverse repos. These transactions fall into two categories: (a) derivatives instruments that will be subject to the conditions of paragraph (c) of Rule 18f-4 and (b) transactions not at all subject to Rule 18f-4.

Derivatives Transactions Are Not Similar to Reverse Repos

Derivatives Instruments. Leveraging transactions can have a passing similarity to one another. For example, once the buyer purchases securities in a reverse repo, the only obligation that remains is for the seller to repurchase the securities for a fixed price at a future date, which is essentially a forward contract. One of the comment letters on Rule 18f-4 attempted to use the economic similarity between total return swaps and reverse repos to argue against treating total return swaps as "senior securities." The Release turned the argument around to justify allowing Funds to treat reverse repos as derivatives transactions under Rule 18f-4.

[We ... appreciate that other types of transactions that would qualify as derivatives transactions ..., such as total return swaps, can achieve economically similar results to reverse repurchase agreements. ... \[Rule 18f-4 addresses\] the concerns raised by fund use of reverse repurchase agreements in a consistent manner as those posed by derivatives transactions under the rule when a fund engages in these transactions \[sic\] beyond the Act's asset coverage requirements for borrowings."](#)

The inclusion of swaps in the definition of "derivatives instruments," and the identification of total return swaps as "transactions that would qualify as derivatives transactions," lead us to conclude that the SEC does not consider any of the [derivatives instruments named in Rule 18f-4](#) (swaps, security-based swaps, futures contracts, forward contracts, options, or any combination of the foregoing) as similar to reverse repos for purposes of paragraph (d). Dollar Rolls. A common form of dollar roll transaction consists of a securities dealer buying mortgage-backed securities from a Fund and simultaneously agreeing to sell the Fund the same principal amount of "to-be-announced" or "TBA" mortgage-backed securities for a lower price. The contemporaneous agreement to sell and repurchase substantially similar securities might make a dollar roll appear similar to a reverse repo. However, the Release states that:

[TBAs and dollar rolls are included in the final rule's derivatives transaction definition because we believe they are forward contracts or "similar instruments."](#)

Additionally, the SEC agreed "that TBAs are not reverse repurchase agreements or 'similar financing transactions' under the rule." See footnote 123.

Transactions that Should Not Be Subject to Rule 18f?4

Here we can indulge in the lawyerly exercise of seeming to contradict ourselves without so doing. Securities Lending. In our last post, we explained that the SEC will treat securities lending as similar to reverse repos if the Fund invests the cash-collateral in securities other than cash and cash-equivalents. The inverse is also true: a securities loan is not a financing transaction similar to a reverse repo:

[if the fund reinvests cash collateral in cash or cash equivalents ..., and the fund does not sell or otherwise use non-cash collateral to leverage its portfolio."](#)

This is because the investment in cash-equivalents would not have a significant leveraging effect on the Fund. Inverse Floaters. The last post also explained that the SEC regarded inverse floaters issued in tender-option bond financings or TOBs as similar to reverse repos. Nevertheless, a Fund may acquire an inverse floater issued in a transaction in which the Fund does not receive proceeds from the sale of the corresponding floaters. This is due to the limited scope of [Section 18](#), which regulates the *issuance* of "senior securities" by Funds, but does not prevent a Fund from *investing* in companies that have issued senior securities. For example, the Federal National Mortgage Association ("**Fannie Mae**") regularly creates collateralized mortgage obligations ("**CMOs**") which divide the cash flows from a mortgage-backed security among the different CMOs. Fannie Mae may create floater and inverse floater CMOs through this process. Because Fannie Mae deposits the mortgage-backed security and receives the proceeds from the sale of the CMOs, it is Fannie Mae, not the Fund, which engages in a financing transaction. Therefore, a Fund's purchase of a CMO inverse floater should not be a financing transaction similar to reverse repo.

Almost Done with Paragraph (d)

Our next post will close out our discussion of reverse repos and similar financing transactions with a short checklist of changes that may be required in a Fund's Section 18 compliance procedures.

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