Blogs
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Asset Management ADVocate

Rule 18f-4 Still Has Commitment Issues

This is the seventh installment of Andrew Cross and my review of the compliance requirements of new Rule 18f ?4 and the first to deal with "unfunded commitment agreements." Before plunging into the substance of paragraph (e) of Rule 18f-4, which regulates unfunded commitment agreements, I want to revisit a problem I have with the definition. My problem stems from trying to answer a basic question: Is a binding commitment to make a loan upon demand by the borrower, with stated principal and term and a fixed interest rate, an "unfunded commitment agreement?"

Definition of Unfunded Commitment Agreement

Rule 18f-4(a) defines an "unfunded commitment agreement" as:

> a contract that is not a derivatives transaction, under which a fund commits, conditionally or unconditionally, to make a loan to a company … in the future …."

A binding commitment to make a loan upon demand by the borrower would appear to fall in this definition, but only if the commitment "**is not a derivatives transaction**." Thus, we need to answer an ancillary question: "Is a binding commitment to make a loan upon demand by the borrower, with stated principal and term and a fixed interest rate, a "derivatives transaction."

Footnote 99

Footnote 99 of the release adopting Rule 18f-4 (the "Release") directly answers this ancillary question.

> [A] fund that enters into a binding commitment to make a loan or purchase a note upon demand by the borrower, with stated principal and term and a fixed interest rate, would appear to have entered into an agreement that is similar to a standby commitment agreement or a written put option. This transaction would expose the fund to investment risk during the life of the transaction because the value of the fund's commitment agreement will change as interest rates change. Such an agreement thus would fall within the rule's definition of 'derivatives transaction.'"

If Footnote 99 accurately reflects the SEC's interpretation of Rule 18f-4, then the answer is that a commitment to make a loan upon demand by the borrower, with stated principal and term and a fixed interest rate, is a "derivatives transaction" and not an "unfunded commitment agreement."

What's My Problem?

The SEC plainly intended that some loan commitments should come within the definition of an unfunded commitment agreement. But if a simple commitment to make a fixed-rate, term loan cannot be an unfunded commitment, what loan commitment could be? Most nominally "variable-rate" loans are actually hybrids of a variable reference rate plus a fixed rate known as the "spread." The market rates for spreads change over time, both for individual borrowers and generally. As a result, the spread included in the interest rate payable under a

loan commitment may be higher or lower than the spread the borrower would pay on a loan made at current market rates. This should give the spread on a variable-rate commitment a potential value that is as least as likely to cause the value of the commitment to change as fluctuations in general rates would change the value of a fixed-rate commitment. So, my problem is I cannot tell when a loan commitment should be treated as a derivatives transaction or as an unfunded commitment agreement.

What to Do?

Readers of this blog may remember I raised this issue when Rule 18f-4 was re-proposed. I also included it in my comment letter on the proposed rule. The Release acknowledged the comment, but reported that I "offered no suggestions regarding how to revise the definition to address this concern." Evidently, I was unclear that my support for the proposal to allow funds to continue to rely on strict asset segregation was intended to address my concern. In any event, the SEC did not include this alternative in the final rule. My inability to suggest a solution to a problem does not (alas) prevent it from being a problem. Many of Andrew and my posts on this blog in the first half of 2020 groped for a bright line for separating firm commitments from unfunded commitments. We ended by pointing the SEC to criteria it and the CFTC had developed to differentiate loans and loan participations from swaps, a suggestion I also made in my comment letter. I can offer only a practical basis for differentiation. An unfunded commitment agreement should be a contract that does not have to be fair valued to calculate a fund's net asset value ("NAV"). If a commitment does not affect a fund's NAV then it cannot lever the fund's performance. The primary risk of such commitments is the fund's ability to meet its obligations and, as we shall see, paragraph (e) of Rule 18f-4 addresses this risk.

Moving On

I hope I've overlooked an obvious answer to my problem. Regardless, from this point forward we will analyze paragraph (e) as though Footnote 99 did not exist, and any loan commitment could be an unfunded commitment agreement.

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