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Transactions that Are “Derivatives Transactions” under Rule 18f-4

In this post, we continue our exploration of the definition of "[derivatives transaction](#)" in new Rule 18f-4, which is relevant to business development companies, closed-end funds and open-end funds other than a money market fund ("Funds"). Our last post discussed examples of derivatives that fall outside of the definition. This post considers transactions that may not pose the risks addressed by Rule 18f-4 but which are nevertheless subject to the rule. Subsequent posts will explain why this overbreadth is not as bad as it might seem.

Future Obligations Are What Matter

We previously discussed how the SEC intends for Rule 18f-4 to address the asset sufficiency (liquidity) and leverage risks that derivatives transactions may entail. We argued that Funds could distinguish unfunded commitment agreements from derivatives transactions based on the absence of leverage risk. It is tempting to push this analysis further to claim that a transaction devoid of both risks should not be subject to Rule 18f-4. This would be a mistake, however. We did not exaggerate when our [last post](#) referred to a "future payment obligation" as the "[touchstone](#)" for a derivatives transaction. Unless the transaction is covered by a separate provision of Rule 18f-4 (e.g., an unfunded commitment agreement), you will rarely go astray in assuming that an investment requiring a payment or delivery of an asset in the future is a derivatives transaction as defined by Rule 18f-4.

Covered Calls

Commenters suggested that the SEC should [exclude "covered calls"](#) from derivatives transactions. The adopting release (the "Release") describes a covered call as "a fund selling a call option where the fund agrees to deliver an asset already held by the fund." The SEC declined to do so because:

[We do not believe it would be appropriate or feasible to identify in rule 18f-4 combinations of derivatives instruments or other investments that, together, may involve less risk or different risks than the constituent transactions considered in isolation. We believe these kinds of relationships are appropriate to assess as part of a fund's derivatives risk management, but do not support excluding the ... transactions ... from the rule's derivatives transaction definition.](#)

A covered call creates neither liquidity nor leverage risks; it just caps the Fund's return at the strike price in exchange for premium income. Nevertheless, the call creates a future delivery obligation, making it a derivatives transaction.

Short Sales Against the Box

The definition of "derivatives transactions" expressly includes "short sale borrowings." On one hand, this is not remarkable; borrowing securities creates an obligation and [Sections 18](#) and [61](#) regulate the creation of senior obligations by a Fund. You might also regard the need to repurchase the borrowed securities to close out the loan as a future payment obligation. On the other hand, a short sale "against the box," in which the Fund already owns the borrowed security, should present neither liquidity nor leverage risk. The Fund can use the security in its "box" to cover the borrowing, so the Fund has sufficient assets to meet its obligation. Shorting against the box

also does not "lever" a Fund's returns; like a covered call, it caps the return at the short sale price, which hedges against a subsequent decline in the security's price. The Release claims that [no one commented](#) on including short sale borrowings in derivatives transactions, so the SEC did not have an opportunity to consider whether to make any exceptions. Given the SEC's position on covered calls, essentially calls "against the box," it would be logical to treat all short sale borrowings as derivatives transactions.

Option Spreads

The SEC also [refused to exclude "option spreads"](#) from derivatives transactions for the same reasons as not excluding covered calls. An [option spread](#) results from purchasing and selling options for the same security at different strike prices. If the option the Fund sold is exercised, the Fund exercises its option to acquire (in the case of a call spread) or dispose of (in the case of a put spread) the optioned securities. The difference ("spread") between the strike prices and the option premiums paid and received, and whether the options are exercised or expire, determine whether the Fund profits from an option spread. Here again, option spreads do not pose liquidity risk. They may create some leverage risk, however, as the Fund's return should reflect the notional amount of the options rather than the amount of the Fund's investment (i.e., the premiums paid and received) in the option spread. Regardless of the risks, the option sold by the Fund is a derivatives transaction notwithstanding the offsetting option. Our next post will summarize our conclusions as to what is and is not a derivatives transaction under Rule 18f-4, before moving on to derivatives risk.

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