Blogs
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Asset Management ADVocate

Why Are Unfunded Commitment Agreements "Senior Securities?"

Subject to Steve's caveat regarding the definition of an "unfunded commitment agreement," we continue our exploration of Rule 18f-4 with a focus on the treatment of such commitments under paragraph (e) of the new rule. Like paragraph (d), (e) applies only to business development companies, closed-end funds and open-end funds other than money market funds ("Funds"). We begin with a conceptual question: how can a contract to lend money and a contract to repay borrowed money both be "senior securities" under Section 18?

Future Payment Obligations Are the Key to 18f-4

The short answer is that a commitment to lend (or invest) money creates a "future payment obligation" for the Fund, as would a promise to repay a loan. "Future payment obligations," a phrase used nineteen times in the release adopting Rule 18f-4 (the "Release"), are at the core of the rule. For example, it explains why purchasing an option is not a derivatives transaction under Rule 18f-4, because the option premium is paid in advance and the Fund does not have to exercise the option and pay the strike price, while writing an option is a derivatives transaction, because the Fund must deliver either cash or the underlying asset if the option is exercised. An unfunded commitment agreement resembles an option in that, if the company elects to draw on the commitment and the conditions for drawing are satisfied, the Fund must pay its share of the drawing, which creates a future payment obligation.

Different Obligations, Different Risks

We discussed the risks addressed by Rule 18f-4 in a post regarding the first proposed version of the rule, so we will just summarize them here using terminology from the Release. First is the risk that a Fund will have enough ready cash to meet a future payment obligation or purchase the assets the Fund is obligated to deliver. The Release generally refers to this as "asset sufficiency" risk. Second is the risk resulting from--

> an investor achiev[ing] the right to a return on a capital base that exceeds the investment which he has personally contributed to the entity or instrument achieving a return."

This will result when the aggregate value of a Fund's portfolio exceeds its net assets. The Release frequently refers to this as "leverage" risk. Any future payment obligation entails asset sufficiency risk. Bank borrowings and reverse repos present leverage risk as well because investing the proceeds in other securities increases the size of the Fund's portfolio (its "capital base") without increasing its net assets (because the liability offsets the added investments). Unfunded commitment agreements are intended to represent a subset of senior securities that should only result in asset sufficiency risk. Thus, unfunded commitment agreements should:

> 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."

In subsequent posts, we will use the presence of asset sufficiency risk and the absence of leverage risk to help identify transactions that should be treated as unfunded commitment agreements and explain how paragraph (e) addresses asset sufficiency risk.

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