



March 29, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE Washington, D.C. 20549

Submitted electronically to rule-comments@sec.gov

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies (File No. S7-24-15).

Dear Mr. Fields:

Hercules Capital, Inc. ("Hercules" or the "Company") appreciates the opportunity to comment on the above-referenced proposal (the "Proposal") issued by the U.S. Securities and Exchange Commission (the "SEC"). Hercules is an internally managed business development company ("BDC") that began investment operations in 2004. Hercules focuses on providing senior secured loans to high-growth, innovative, venture capital-backed companies in broadly diversified industries of technology (software and hardware), life sciences (drug discovery, healthcare and medical devices) and sustainable and renewable technology. Hercules is concerned about the Proposal and the impact it would have on the Company's ability to continue to provide important financing to its constituent borrowers.

Hercules believes that unfunded loan commitments ("Unfunded Commitments") made by BDCs and other funds should not be treated as "financial commitment transactions" as such term is defined in the Proposal. Hercules believes that the Staff's position that Unfunded Commitments should be treated as a "senior security" for purposes of Section 18 of the Investment Company Act of 1940, as amended ("Section 18") is misguided.

As detailed below, Unfunded Commitments held by Hercules and other BDCs vary greatly from the other types of commitments that the Proposal bundles into the definition of "financial commitment transaction" and the types of transactions that have been deemed to be "senior securities." In addition, the treatment of Unfunded Commitments for purposes of the proposal is inconsistent with U.S. Generally Accepted Accounting Principles ("GAAP"). Most importantly, the impact of treating Unfunded Commitments as "financial commitment transactions" could limit Hercules' ability to continue to provide important debt capital to innovative companies and put the Company at a competitive disadvantage to other lenders to venture-backed companies.

Hercules provides loans to venture capital-backed companies that are in the development stage of their life cycle. These companies typically have little to no revenues and a high cash burn-rate. Portfolio companies that borrow from Hercules often need financing to bridge them from one capital event to the next, using the debt financing provided by Hercules to enhance shareholder value and improve the portfolio companies' financing options and position.



Given the growth profile of Hercules' portfolio companies, offering loans with a portion that is an Unfunded Commitment affords Hercules the flexibility to structure debt financing that is specifically tailored to the portfolio companies' needs while reducing costs and minimizing undue risk to Hercules' shareholders. The Unfunded Commitment is critical to Hercules because it allows the Company to offer financing in a fashion that allows greater funding to portfolio companies as they grow and become increasingly more established. Thus, these types of Unfunded Commitments will become available to a portfolio company based on critical milestones achieved by the company, such as financial performance, product achievements, capital structure accomplishments, etc.

For example, Hercules will offer a company a loan of \$25 million, with \$15 million funded at closing and another \$10 million offered in the future, but only if the company can achieve specific milestones. It is important to note that achievement of these milestones are far from guaranteed, and it is often the case that companies do not achieve the required milestones, leaving Hercules with no obligation to provide additional debt capital. In addition, the Company, from time to time, will also offer revolving lines of credit to portfolio companies, which provide a valuable source of on-demand financing to meet working capital needs of its portfolio companies. These revolving lines are used on an as needed basis and are rarely fully drawn for extended periods of time, if at all.

Based on the nature of Hercules' Unfunded Commitments, the Company believes that its Unfunded Commitments are dissimilar from the other types of transactions defined as "financial commitment transactions" in the Proposal. Unlike a reverse repurchase agreement, firm or standby commitment or short sale borrowing (all defined as "financial commitment transactions" in the Proposal), a commitment to provide debt capital at some future date based on a contingency, which may or may not occur, is significantly less likely to result in a BDC having an obligation to loan money to a portfolio company. Similarly, Unfunded Commitments do not bear the same qualities as other types of transactions that have been deemed to be "senior securities" under Section 18.

In a typical loan origination involving an Unfunded Commitment, the Company funds a portion of the aggregate commitment at the time of the initial closing with the remainder of the loan unfunded and subject to the portfolio company meeting milestones of the type discussed above. The Unfunded Commitment generally expires in six to 18 months and often expires without being fully drawn by the portfolio company.

In treating Unfunded Commitments as "financial commitment transactions," the Company believes that the Proposal is overly broad and views all commitments to provide capital at some future date as equal, when in reality the nature and types of commitments that the Company and others may enter into are very broad and take into account various terms and structures. Most importantly, often the types of commitments that are made by the Company are highly contingent on the achievement of milestones, many of which are not met, resulting in the Company not needing to fund its Unfunded Commitments. This mismatch between the types of transactions the Proposal defines as "financial commitment transactions" is highlighted by the fact that over the last 11 years, the Company has had a forfeiture rate of over half of its Unfunded Commitments, resulting in no capital required to fulfill Unfunded Commitments. Based on this historical forfeiture rate for the highly contingent Unfunded Commitments typically held by the Company, it would be unreasonable for the Company to treat 100% of all Unfunded Commitments as a "financial commitment transaction" and would ignore the economic realities of the Unfunded Commitments and the impact they have on the Company's portfolio.



For example, where the Company's obligation at some future date is contingent upon meeting certain milestones, at a minimum, it would be appropriate to offset its total amount of Unfunded Commitments with the income received from amortizing loans and scheduled prepayments that will occur before the Unfunded Commitments become available to the portfolio company. Such an approach would more effectively reflect the realities of these transactions because if a portfolio company fails to make payments between the time a loan is made and the date the Company has an obligation to fund an Unfunded Commitment to that portfolio company, the Company's obligation would be extinguished.

In the event that SEC moves forward with the Proposal, the Company suggests that it reconsider the definition of "financial commitment transactions" to recognize that Unfunded Commitments that are contingent on the borrower's satisfaction of various representations, warranties and financial and non-financial covenants (collectively, "*milestones*") should not be treated as "financial commitment transactions" or "senior securities." Such milestones typically include, but are not limited to:

- timing (180 days to 365 days after initial funding);
- meeting revenue or EBITDA targets or projections in the current year that are not available until the following year;
- meeting predefined targets in a clinical study;
- Federal Drug Administration positive results or approval; and
- successful completion of a capital raise.

Until the portfolio company reaches such a milestone, the Company is under no obligation to fund any part of its Unfunded Commitment. In addition to reaching milestones, Unfunded Commitments are typically subject to a variety of other terms and covenants in the loan agreement that further underscore the contingent nature of the Company's Unfunded Commitments. To more accurately reflect the nature of these Unfunded Commitments, the Proposal should be revised to reflect the highly contingent nature of these Unfunded Commitments and account for the fact that there is a wide range of Unfunded Commitments and some are much less contingent in nature than the type engaged in by Hercules in the normal course of its business.

Based on the facts outlined above, the Proposal's stated concern that Unfunded Commitments will expose a BDC to additional risk because "the [BDC] may be required to liquidate other assets of the fund to obtain the cash needed by the fund to satisfy its obligations, and if the fund is unable to meet its obligations, the fund would be subject to default remedies available to its counterparty" are unavailing. Similarly, in Investment Company Act Release No. 10666, the Commission Staff stated: "[t]he legislative history of the [Investment Company] Act indicates that Congress intended Section 18, *inter alia*, to limit increases in the speculative character of junior securities issued by investment companies. Leveraging of an investment company's portfolio through the issuance of senior securities and through borrowing magnifies the potential for gain or loss on monies invested and, therefore, results in an increase in the speculative character of the investment company's outstanding securities." Contrary to the policy concerns behind Section 18 and prior guidance from the SEC, Unfunded Commitments made by a BDC do not have a leveraging effect on the BDC, nor do they increase the investment risk or magnify the potential for gain or loss on money invested by the BDC.

The conditional obligations of the type engaged in by Hercules exposes the Company to the risk of default only after the contingencies have been met. Before a contingency is met, a BDC has no obligation



to provide additional capital to the portfolio company, and, thus, the conditional obligation does not subject the BDC to any current liquidity risk, nor does it have a leveraging effect. We urge the SEC to reconsider its Proposal to reflect that Unfunded Commitments should be treated only as "financial commitment transactions" at such point as they are no longer highly contingent and uncertain.

Finally, the Proposal's treatment of Unfunded Commitments as indebtedness or other types of transactions that would have a leveraging effect on a BDC is inconsistent with how Unfunded Commitments are treated by a BDC under GAAP. Amounts that are committed by a BDC, but are not yet drawn by a borrower, are not treated as liabilities of the BDC in the BDC's financial statements. For starters, Unfunded Commitments do not represent indebtedness under relevant accounting rules and guidance. In addition, there is no amount that has been borrowed by a BDC in connection with an Unfunded Commitment, no liability that is required to be recorded as a liability under GAAP, no security interest that has been granted by the BDC to any third party and no amount that is required to be repaid by the BDC, whether on demand or otherwise. Unlike indebtedness (which would generally be required to be repaid upon the liquidation of the BDC), there is typically no binding obligation or commitment by a BDC to fund any portion of an Unfunded Commitment to a portfolio company upon the liquidation of the Fund or otherwise.

Furthermore, Unfunded Commitments are not subject to, and are specifically excluded from, ASC Topic 815 – Accounting for Derivatives. The purpose of an Unfunded Commitment is to provide the portfolio company's management with flexibility in its borrowing and cash management needs and there is no predetermined required funding obligation. Thus, the accounting rules and guidance reflect the contingent nature of Unfunded Commitments. For all of the reasons outlined above, Hercules respectfully submits that Unfunded Commitments are a cash management issue for BDCs, not a regulatory issue requiring additional and unnecessary rulemaking for a class of transactions which do not create increased credit risk or risk of loss for a BDC.

While Hercules appreciates the SEC's efforts to provide clarity on the treatment of Unfunded Commitments in the Proposal, the Proposal is overly broad and fails to properly reflect the highly contingent nature of Unfunded Commitments and the wide array of Unfunded Commitments issued by BDCs. As currently drafted, the Proposal would negatively impact the ability of Hercules and others to provide important capital to innovative companies without providing any benefits to BDC shareholders or reducing risk in BDC portfolios. With that being the case, we urge the SEC to re-consider the Proposal and revise it to accurately reflect the true nature of Unfunded Commitments and develop a Proposal that would not negatively impact the ability of BDCs to provide important financing to their portfolio companies. We appreciate the opportunity to comment on the Proposal and would welcome the opportunity to meet with the SEC staff to further discuss our comments. If we can provide further information, please do not hesitate to contact me at [REDACTED].

Yours Truly,

A handwritten signature in blue ink, appearing to read "Mark R. Harris", written over a horizontal line.

Mark R. Harris
Chief Financial Officer
& Chief Accounting Officer