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March 28, 2016

VIA ELECTRONIC DELIVERY

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Use of Derivatives by Registered Investment Companies and Business Development Companies; Release No. IC-31933; (File No. S7-24-15)

Dear Mr. Fields:

I am writing on behalf of various business development companies ("BDCs") to comment on the Commission's proposed Rule 18f-4 (the "Proposed Rule")[1] under the Investment Company Act of 1940 (the "Act"). These comments reflect my views on their behalf and do not represent the views of my firm.

Business Development Companies

BDCs were created by Congress in 1980 in order to create a form of investment vehicle that would supply capital to private and thinly traded U.S. based operating companies and that could do so within a modified regulatory framework compared to registered investment companies. These private and thinly traded companies have been very important engines of job creation in the U.S., and the availability of capital to this sector is critically important to our economy. They serve a different legislative purpose than registered closed and open end funds that must be taken into account in devising regulations that would apply to them. Due to the critical function of BDCs in the capital formation process for these companies, it is particularly important for the Commission to pay close attention to the requirement of Section 2(a) of the Act

[1] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. 1C-31933 (12/11/2015), 80 Fed. Reg. 80884 (12/28/2015) (the "Proposing Release"). Page references are to the Federal Register pagination.

that the Commission considered whether the proposed regulation will promote efficiency, competition, and capital formation.

For a variety of reasons, commercial banks by and large have reduced or eliminated their lending to these businesses. In response to this need, BDCs have grown from only a few billion dollars in total assets in 2006 to over $80 billion at present.

BDCs are closed end investment companies, enjoying permanent capital without any risk of redemptions. However, they do not register under the Act and are regulated differently than registered funds. Particularly because Congress did not intend BDCs to be subject to numerous requirements applicable to registered investment companies and relaxed numerous other elements of the Act to enable BDCs to perform their intended mission, the Commission should carefully assess whether any new area of regulation should apply to BDCs and, if so, to what extent and in what manner. In this regard, the Commission needs to take into account the differences between the direct lending businesses engaged in by BDCs and the speculative trading techniques employed by many regular investment companies.

Parts of the Proposed Rule, in accordance with past practice, simply should not apply to BDCs, while other parts need to take more account of the differences between BDCs and registered funds, particularly open-end funds. In addition, the Commission appears to lack authority to adopt this Proposed Rule in the form proposed.

As the Release notes, BDCs by and large do not use derivatives very much[2] . By law they must invest at least 70% of their assets in effect in securities of U.S. based operating companies that are either private or thinly traded. Most BDCs primarily provide debt financing to such companies and accordingly have little need for most types of derivatives transactions, with only interest rate and currency hedging transactions being commonly used. Some BDCs do, however, engage in financial commitment transactions, almost entirely in the form of unfunded contingent loan commitments. My comments on the Proposed Rule will accordingly address financial commitment transactions first and then derivatives. At the end I will discuss the apparent lack of authority for the Commission to adopt the Proposed Rule in the form proposed.

Financial Commitment Transactions

At least as used by BDCs unfunded contingent loan commitments should be excluded from the definition of financial commitment transactions and should not be treated as derivatives, thereby excluding them from coverage under the Proposed Rule. This was essentially the conclusion of the Commission's Division of Investment Management just this past October. After the better part of a year of considering whether they should be treated as senior securities, the Division of Investment Management determined in October 2015 that, as used by BDCs, such commitments should not be treated as senior securities if a BDC can represent (and support such representation) to the staff of the Commission that the BDC reasonably believes it has sufficient resources to fund such commitments under their terms. The same protocol should apply to closed end funds that engage in the same lending activities as BDCs.

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[2] Proposing Release at 80911 and n. 215 and at 80913.

It is, consequently, highly surprising to find in the Release that the Commission is proposing not only to treat such commitments as senior securities but to treat them differently from all other derivatives and require far more onerous amounts and forms of cover.

From both a policy and an interpretive point of view, the treatment in the Proposed Rule is erroneous and should be corrected.

1. *Policy*. BDCs are largely in the business of making loans to private companies. While many loans are fully funded at closing, often a company needs only a portion of the money at that time but wishes to have the prospect that, as long as it continues to be healthy from a financial point of view, it will have access to additional credit as needed. In other cases a company wishes to line up the availability of credit as long as it continues to be healthy from a financial point of view but has no current intention of drawing on that credit facility. This is normal, prudent, ordinary course commercial behavior by these companies. And entering into commitments to make such loans is a normal, prudent and ordinary part of most BDCs' core business of making loans.

Treating unfunded contingent loan commitments as financial commitment transactions under the Proposed Rule will effectively force BDCS to curtail their lending business. This is because holding cash and cash equivalents against these contingent obligations is uneconomic and would require BDCs either to charge much more for these facilities than any business would rationally agree to pay or to terminate an integral part of some lending relationships. This would have the perverse effect of reducing the access of Main Street to credit from BDCs just when banks are also reducing the availability of such credit. Since BDCs have been engaged in this business activity for many years without any instance of their being unable to fund a commitment when required to do so, the Proposed Rule's treatment of unfunded contingent loan commitments is unnecessary, inimical to the fundamental policy purposes for which BDCs were created and unsupported by any economic analysis under Section 2(a) of the Act.

2. *Legal Analysis.* I would urge the Commission to recognize that unfunded contingent loan commitments are very different from the speculative betting on interest rates and credit risk by open end funds in relation to the firm commitments and standby agreements discussed in SEC Release No. IC-10666 (4/18/1979) ("Release 10666")[3]. Unfunded contingent loan commitments should be excluded from treatment as financial commitment transactions, as well as from being classified as derivative transactions, and instead should be treated the way approved by the Commission's Division of Investment Management just this past Fall. The Commission itself reached this conclusion in Release 10666. Specifically, the Commission stated that commitments to purchase securities "whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in this general statement of policy. Such commitments . . . have no discernible potential for leverage."[4] There is no analytical support for reversing that conclusion.

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3 They are also very different from the noncontingent capital commitments by investors to a private fund that were discussed in the Proposing Release at 80900.

4 Release 10666 at n. 12.

Unfunded contingent loan commitments do not exhibit the characteristics of the firm commitments and standby agreements discussed in Release 10666. Those forward commitments and standby agreements were nonconditional agreements to buy from a broker -dealer usually at a specific date in the case of a firm commitment and at the option of the seller in the case of a standby agreement, a specific amount of a very long term debt security paying a fixed interest rate determined at the time of the commitment. As a result the fund was unconditionally exposing itself to interest rate risk, credit risk of the issuer and credit risk of the counterparty. As noted in Release 10666 firm commitments and standby agreements created the potential for relatively large amounts of gain or loss without any investment by the fund. The Commission believed these agreements posed a risk of loss to the fund analogous to the risk of leverage and were excessively speculative in light of the purpose of Section 18 of the Act.

Unfunded contingent loan commitments used by BDCs, in contrast, are contingent, have very little interest rate risk, very little credit risk and no counterparty risk. This is because they (1) are uniformly floating rate based on short-term LIBOR rates with LIBOR floors generally not in excess of 1%; (2) have funding conditions that excuse the BDC from funding if the borrower does not continue to satisfy various representations, financial and non-financial metrics and performance conditions relating directly to the borrower's creditworthiness and are often made to companies that may not even draw on the commitments prior to expiration; (3) are, if funded, prepayable at any time with little or no penalty; and (4) are contracted for directly with the issuer and not a third party intermediary. Because of these features unfunded contingent loan commitments represent little or no potential for gain or loss by the BDC and do not pose risks of loss analogous to leverage. In particular, they (i) cannot be sold at a profit even if interest rate spreads contract because the potential borrower might never borrow and if it does borrow may prepay with little or no prepayment charge and (ii) cannot result in substantial risk of loss prior to funding because the BDC is not required to fund the loan if the potential borrower's credit or financial position degenerates meaningfully. As noted above, the Commission itself reached this conclusion in Release 10666 with respect to noncontingent commitments so long as the fixed rate interest rate exposure did not commence until purchase date.

Further, unfunded contingent loan commitments represent an ordinary course element of the lending business most BDCs focus on. Particularly because BDCs are required by the Act to invest most of their assets in private and thinly traded US operating companies, they were not set up by Congress to maintain cash assets to segregate against these contingent ordinary course obligations and would not be able to comply with the requirements in the Proposed Rule without undermining their statutory function. I believe that the drafters of the BDC provisions of the Act, who were members of the Commission's staff and were well aware of the then recently issued Release 10666 when they drafted the BDC provisions, had no intent to subjugate BDCs to capital set asides for ordinary course lending transactions. Indeed, since the Commission had excluded similar arrangements from coverage under Release 10666, the drafters would have had to go out of their way to treat them as senior securities, which they did not do.

Any final rule or guidance by the Commission should accordingly define "financial commitment transaction" more narrowly along the following lines:

> any reverse repurchase agreement, short sale borrowing, or any firm, standby commitment or similar agreement obligating a fund to make a loan to or invest in

> the debt or equity securities of a company, which obligation is subject to no substantive requirements that have not been satisfied other than the passage of time and the discretion of the company or its agent and is not in the course of settlement or closing within a commercially reasonable timeframe.

The Proposing Release does suggest[5] that qualifying coverage assets could include assets that are convertible to cash or that will by their terms generate cash equal to the fund's contingent obligation prior to the date on which the fund can be expected to be required to fund the loan. This suggestion makes use to a limited extent of the principle underlying the protocol fashioned by the Commission's Division of Investment Management in October 2015 that a BDC be able to represent that it has sufficient sources of liquidity to handle funding of the contingent loan commitments that it expects to be required to fund. Whether or not the Commission determines to retain treatment of financial commitment transactions that is separate from its treatment of derivatives transactions (see discussion below), it should make modifications that are consistent with the Staff's approach for unfunded contingent loan commitments and similar ordinary course funding arrangements[6]. This approach enables a BDC to take into account the likelihood of funding, its borrowing capacity, its rights to call or issue additional capital, upcoming maturities of portfolio instruments held by the BDC, scheduled interest and principal payments, potential prepayments of principal, potential of sales of assets and any other relevant facts rather than being limited (as in the Proposed Rule) to events that contractually will generate cash. In effect, the Commission needs to take into account the differences between the direct lending businesses engaged in by BDCs and the speculative securities trading techniques employed by regular investment companies. In addition, there is no reason why a BDC's board of directors needs to be involved in approving policies or procedures for routine business determinations of this sort. While boards should be involved in conflicts and general oversight, it is not sensible to ask for their involvement in normal day-to-day business operations.

3. *Related Matters.* Separate and apart from the need to revise the definition of financial commitment transactions to exclude unfunded contingent loan commitments, the limits for financial commitment transactions in the Proposed Rule would be much too conservative for BDCs, which are under current law permitted to incur indebtedness for borrowed money in an amount equal to their common equity – – twice as much leverage as is permitted to open-end funds. Use of a 150% net asset coverage standard would leave little room for financial commitment transactions. A "one size fits all" percentage cap chosen in relation to the leverage limitations and redemption obligations applicable to open-end funds and expressed in relation to

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5 Proposing Release at 80947.

6 To mention a few examples, a BDC may enter into joint ventures or agreements relating to the funding of a new business venture that are contingent on the venture getting to operational stage or meeting various revenue, asset generation, third party funding or other conditions or milestones; a BDC may enter into a loan commitment that is intended from the outset to be funded in parts at two or more specific dates; or a BDC may enter into an unfunded revolver with an existing portfolio company in order to maintain its lending relationship with the company or forestall competition by other lenders. These types of transactions are ordinary course features of a lending business and do not have the hallmarks of the investment trading instruments discussed in Release 10666.

net assets is not appropriate and fails to reflect the regulatory structure Congress enacted in Sections 18 and 61. At a minimum, any final rule or guidance should reference an amount providing headroom over and above permissible leverage levels for any particular fund under Section 18 or Section 61 rather than a single percentage of assets applicable to all types of funds. Such a provision would be cast in terms of a percentage of total permissible assets, where permissible assets would be defined as net asset value plus permissible total leverage under the Act, thereby floating automatically with the different amounts of leverage permitted to different types of investment companies.

Even in the context of open end funds, noncontingent financial commitment transactions should not be subject to a different regime than other derivatives, as there is nothing in their structure or market dynamics that would suggest they produce substantially different risks. In particular, liquid forward commitments and standby agreements of the type discussed in Release 10666 should only require cover on a mark to market basis.

Staff guidance or the release accompanying any reproposal or adoption of a rule should clarify several other interpretive matters. These comments are also applicable to other types of investment companies.

- One is that ordinary course settlement time frames in the BDC industry do not give rise to financial commitment transactions. These time frames often can be up to a few months between a commitment letter and funding upon closing under definitive documentation and can even take a month or more between the signing of definitive loan documents and the actual funding.

- A second is that commitments that can be terminated by the BDC or as to which the BDC has discretion whether or not to fund should not even be treated as unfunded commitments.

- Third, with respect to any transactions for which segregation would be required, available borrowing capacity of the BDC under existing credit facilities should be treated the same as cash and cash equivalents.

- A fourth is that to the extent any obligation is treated as a financial commitment transaction, the asset that would be generated upon funding the commitment should be treated as an asset.

Derivatives Transactions

Inasmuch as BDCs generally do not utilize derivatives other than for currency and interest rate hedging, any guidance or final rule should provide that any BDC that restricts its use of derivatives to hedging and risk reduction purposes should simply not be subject to the guidance or rule. In addition, in my view it is regulatory overkill to apply a complicated rule to funds that use derivatives for investment purposes but only to an immaterial extent. Currently the entire Proposed Rule applies if a fund uses a single dollar of derivatives in excess of net risk reduction. There should be an appropriate safe harbor, such as derivatives with a value of less than 25% of a fund’s permissible total assets, below which a fund is not subject to the rule.

In respect of derivative transactions, as a general matter the Proposed Rule is far more complicated than necessary, especially with respect to closed-end funds and BDCs. Rather than mandate a specific limit on the amount of derivatives without regard to the nature of the derivative and then piling on segregation requirements, risk increments and risk programs, the Commission should divide derivatives into liquid instruments and illiquid instruments. It should then impose no limit on liquid instruments other than mark-to-market segregation and should impose a tiered limit plus mark-to-market segregation on illiquid instruments where the limit on illiquid instruments would be equal to specified levels of a fund's permissible total assets, which would be not less than 15% in the case of an open-end fund and not less than 100% in the case of a closed-end fund or BDC.[7] Liquid instruments would include any instrument regularly traded on an exchange or other market and any instrument that the fund has the right to terminate on not more than seven days' notice. For any instrument dependent on termination rights for liquid status, the mark-to-market segregation requirement would include any termination cost in excess of the mark-to-market amount. Sources eligible for segregation should include not only cash and cash equivalents but also any liquid high grade debt instrument with a final maturity of no more than 270 days and any borrowing capacity under any line of credit accessible for investment purposes.

This framework would greatly simplify compliance with the Proposed Rule while working with established mechanisms and metrics.

If the Commission nonetheless determines to utilize the general framework contained in the Proposed Rule, several substantial changes need to be made to reflect the capital structure differences between closed-end funds and BDCs from open-end funds.

First the 150% limitation should be adjusted in order to be a percentage of permissible total assets rather than a single fixed percentage of net assets, which fails to take into account the Congressionally mandated leverage differences between closed and open end funds under Section 18 and, for BDCs, Section 61 of the Act.

Second, incremental risk based amounts should not apply at all to closed-end funds and BDCs. They are not subject to redemptions and accordingly have no requirement or potential pressure to close out a derivative in stressed conditions. As a result, risk-based amounts are not relevant to them.

Third, if open-end funds are subjected to a risk regime, the mark-to-market segregation requirements amount must be credited against any risk-based amount. Requiring, as the Proposed Rule does,[8] that the total segregation requirement be the sum of the mark-to-market amount plus the risk-based amount seems to be double-counting.

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[7] This would result in a limit – solely for illiquid derivative transactions – of not less than 22.5% of net assets in the case of an open-end fund and not less than 200% for a closed-end fund or BDC under the current law. Higher amounts than these may be appropriate. A fund that is not permitted to issue senior securities would be limited to the specified percentage of its net assets for illiquid derivatives. Open end funds would be required to deduct any other illiquid assets owned by them.

[8] Proposing Release at 80929.

Fourth, the final rule or any reproposing or adopting release or other guidance should make clear that a non-recourse instrument is not a derivative at all for these purposes since there is no incremental exposure to the fund. Concomitantly, any instrument on which a fund's liability is contractually capped would not in any circumstance have a mark-to-market or risk-based amount in excess of the cap less amounts already invested.

Form of Regulatory Framework

In the Proposed Rule, the Commission definitively defines a wide range of instruments as senior securities for purposes of Section 18 and then adopts a specialized regime for dealing with these newly minted senior securities. The difficulty with this approach is that many of these instruments clearly are not senior securities and the Commission has no authority to expand Congress' definition of senior security to suit its own views as to what the term should mean. As a consequence, the Proposed Rule should be implemented as guidance, rather than a rule or, if adopted as a rule, should be adopted as a safe harbor rule or one regulating only instruments that clearly are senior securities.

In Release 10666, which contains the Commission's original thinking on the problems of certain trading practices in open-end funds in relation to Section 18 of the Act, the Commission was quite careful to treat the instruments discussed therein as having a similar leveraging effect to borrowings under Section 18 and not to make a finding that they are senior securities. Further, the fund industry has never been in agreement that unfunded commitments or derivatives are by their nature senior securities. The definition of senior security in Section 18(g)[9] requires that a senior security be both a security and also either evidence indebtedness or be a stock having priority as to dividends or liquidation over some other class of stock. Many derivatives, such as currency and commodity forwards, are not securities; and many other derivatives, such as cash settled swaps, represent indebtedness of the fund only if the fund becomes obligated to post additional margin, which often never happens, either because the swap is non-recourse or because the underlying values only move in favor of the BDC.

Unfunded commitments similarly do not satisfy the definition of senior security, and as discussed earlier the Commission expressly came to this conclusion in Release of 10666 with respect to commitments the tenor of which is not locked in at the time the commitment becomes a fixed obligation. It is also difficult to conclude that Congress would, as it did in Section 18(c), provide that closed end funds may issue only a single class of indebtedness if Congress thought that unfunded commitments and derivatives were senior securities since most investment company debt is secured and most derivatives and unfunded commitments are not.

In the Proposing Release the Commission claims that Sections 6(c), 12(a), 31(a) and 38(a) provide a basis for the Proposed Rule. Examination of these sections does not support that claim. Section 6(c) is purely an exemptive rule permitting relaxations of requirements, whereas the Proposed Rule first seeks to expand the Act's prohibitions and only then to provide partial

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9 The definition of "senior security" appears solely in Section 18(g) and accordingly is not subject to the "unless the context otherwise requires" proviso applicable to the definitions appearing in Section 2 of the Act. Consequently, the Commission is more constrained in the interpretation of the term.

relief from its newly created prohibitions. Section 12(a) palpably has nothing to do with any derivative or unfunded commitment other than borrowing for short sales. Section 31(a) deals with books and records and accordingly provides no authority for any of the substantive provisions of the Proposed Rule. Section 38(a) confers authority only to adopt rules necessary for the exercise of authority conferred elsewhere in the 1940 Act. The problem here is that the 1940 Act gives the Commission no authority to modify the definition of senior security, and the Commission does not have authority to turn Section 38(a) into an all encompassing independent grant of authority.

Inasmuch as Congress defined the term senior security in such a way that the Commission, as noted earlier, is powerless even to vary its meaning according to the context, the Commission should narrow the scope of the Proposed Rule to instruments that clearly are senior securities in order to adopt a true exemptive rule applicable to them, adopt a safe harbor rule funds may choose to rely on, or provide comprehensive guidance updating Release 1066. Any of these courses of action would permit the Commission to harmonize and modernize this area of fund activity without taking steps that appear to subject it to reversal by a court.

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I hope the Commission and its staff find these comments to be useful. As always, I would be happy to discuss any of them with the staff.

Sincerely,

/s/ Richard T. Prins