March 28, 2016

Mr. Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549-1090

Re: SEC File No. S7-24-15 (RIN 3235-AL60): SBIA Comments on the Proposed Rule on the Use of Derivatives by Registered Investment Companies & Business Development Companies

Dear Mr. Fields:

The Small Business Investor Alliance ("SBIA") appreciates the opportunity to comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed Rule 18f-4, which is designed to regulate the use of derivative transactions and financial commitment transactions by funds, including business development companies ("BDCs") regulated under the Investment Company Act of 1940, as amended ("'40 Act").[1]

SBIA is a national association that develops, supports, and advocates on behalf of policies that benefit investment funds that finance small and mid-size domestic businesses in the middle market and lower middle market, as well as the investors that provide capital to these funds. Our membership consists of traditional 3(c)(1) and 3(c)(7) private funds, funds and their investment advisers that have been licensed or are seeking to be licensed by the Small Business Administration as small business investment companies ("SBICs"), funds electing BDC status under the '40 Act, and the investors that invest in these funds, including, but not limited to, banks, family offices and funds of funds.[2] SBIA is the primary association representing the growing BDC industry.

[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80883-80996, (December 28, 2015); *see also* SEC File No. S7-24-15 (December 28, 2015) ("Proposed Rule").

[2] SBIA currently has 165 individual fund/investment adviser members and 40 BDC members.

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The Proposed Rule, if it is implemented, will result in detrimental impacts on BDCs and the businesses that rely on them for credit in the middle market, lower middle market and venture lending space. SBIA encourages the Commission to evaluate our comments in the context of the special mission of BDCs and to conduct a thorough analysis into the financing and leverage differences of BDCs as compared to open-end and closed-end funds.

I. BDCs are Treated the Same as Open-End and Closed-End Funds in the Proposed Rule, without Recognizing the Unique Attributes of BDCs

BDCs were authorized in 1980[3] to "mak[e] capital more readily available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing."[4] The Proposed Rule disregards the special Congressional intent in the purpose of BDCs, by treating BDCs exactly the same as open-end and closed-end funds.

At their creation, BDCs were added to the '40 Act as a hybrid, having some reporting requirements of an operating company, and some of an investment company, as well as mission-driven differences in the types of the investments they could make. In general, the Proposed Rule arises in many respects out of SEC Release No. IC-10666[5] ("Release 10666"), which did not contemplate BDCs. Release 10666 was drafted and issued prior to the passage of BDC legislation in 1980.[6] Nor does the Proposed Rule account for certain unique designation and attendant rights afforded to BDCs as distinct from other open-end funds (including exchange-traded funds) and closed-end funds. It's important to look at certain differences that apply in the context of the Proposed Rule.

One of the most important differences of a BDC from other '40 Act funds is that Congress explicitly granted BDCs the ability to leverage more than other '40 Act funds, with their asset coverage ratio set at 200% rather than 300% for other '40 Act funds.[7] The new limitations, by treating BDCs and other '40 Act funds the same when they utilize derivatives, counteracts these recognized differences. The Proposed Rule requires all funds, including BDCs, that engage in derivatives transactions to limit such fund's aggregate exposure to 150% of the value of the

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[3] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2274 (Oct. 21, 1980).

[4] Definition of Eligible Portfolio Company Under the Investment Company Act of 1940, SEC File No. S7-37-04 (November 30, 2006), *available at:* *https://www.sec.gov/rules/final/2006/ic-27538.pdf*

[5] Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25128-25134 (April 27, 1979); SEC Release No. IC-10666.

[6] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2274 (Oct. 21, 1980).

[7] Investment Company Act of 1940, Section 61(a)(1); Section 18(a)(1)(A).

fund's net assets or 300% of the value of the fund's net assets in cases where such fund's full portfolio value at risk ("VaR") is less than such fund's securities portfolio VaR (excluding derivatives).[8] This approach treats all the funds similarly, without recognizing the special attention paid by Congress to increasing the amount of exposure that a BDC can take on, in accordance with their special mission to lend to small and mid-size businesses.

Part of the rationale for permitting BDCs to access additional leverage, BDCs are involved in a very different business than most '40 Act funds. BDCs were designed to make equity and debt investments in privately-held small and mid-size companies. Under the requirements of the '40 Act, BDCs are required generally to invest at least 70 per cent of a BDCs total assets in private securities acquired from "eligible portfolio companies" or similar assets and provide management assistance to these companies, with the remaining 30% invested in other "non-qualifying assets."[9] In contrast, many open-end and closed-end funds engage in little or no direct financing transactions with portfolio companies, but rather primarily invest on the secondary basis in the capital markets.

These differences speak to the Congressional intent of creating BDCs – as a separate and distinct structure from an open-end or closed-end fund. BDCs are permitted to access and deploy more capital than other funds to carry out their extensive mission of investing in smaller, private companies. They are also required to have more disclosure to their investors as a result – creating transparency to reflect the increased privileges they were granted by Congress. The Proposed Rule, by treating BDCs the same as other '40 Act funds, goes in the opposite direction of what Congress intended, for instance, by capping their use of derivatives to that of what a '40 Act fund should be doing, or by treating their revolving lending facilities as financial commitment transactions, thereby subjecting them to coverage requirements, as discussed in greater detail below. Both of these new restrictions in the Proposed Rule directly limit (and as a result will effectively curtail certain aspects of a BDC's lending business) BDCs from conducting the full extent of providing capital for small and mid-size businesses, as intended by Congress. In line with Congressional intent, BDCs should also be treated differently here, as they were when they were created. Due to these differences, the Proposed Rule should provide extra flexibility for BDCs to reflect the special mission and function of these funds.

II. The Commission Should Provide More Flexibility for BDCs in the Proposed Rule Provisions on Financial Commitment Transactions

[8] Proposed Rule at 408-409; Proposed Rule 18f-4(a)(1)(i) and (ii).

[9] Investment Company Act of 1940, Section 55(a).

The definition of a "financial commitment transaction" in the Proposed Rule includes any "agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner."[10] Under the Proposed Rule, a fund engaging in financial commitment transactions, including what are commonly referred to as "unfunded commitments" would be required to maintain "qualifying coverage assets" which would be limited to: (i) cash and cash equivalents; (ii) with respect to any financial commitment transaction under which the fund may satisfy its obligations under the transaction by delivering a particular asset, that particular asset; and (iii) assets that are convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation or that have been pledged with respect to the financial commitment obligation and can be expected to satisfy such obligation, determined in accordance with policies and procedures approved by the fund's board of directors.[11]

Applying the Proposed Rule's definition of "financial commitment transaction" and its concomitant requirement to provide qualifying coverage assets[12] to BDCs, does not adequately take into account the diverse range of BDC's financing facilities, and the varied terms and structures of those facilities. SBIA, on behalf of the BDC industry, believes that the financing instruments used by BDCs, and in particular unfunded commitments to portfolio companies, are generally outside the issues addressed in Release 10666, and should not be subjected to treatment as senior securities under Section 18 of the '40 Act. We encourage the staff to take a fresh look at its position on this issue, and engage in a dialogue with industry. A potential solution, acceptable to our members, and providing certainty to investors, would require having BDC boards of directors' review on a periodic basis the question of whether the BDC has sufficient assets to cover any unfunded commitments. This position would provide certainty and protection for investors, and in fact was adopted in principle by much of the industry after close discussion with the staff of the Division of Investment Management in 2015 (under that position, certain BDCs certify that they have sufficient assets to cover unfunded commitments).

If the Commission is not open to revisiting this issue, it should clarify and narrow the definition of a financial commitment transaction to ensure that only those transactions that present actual and concrete commitments to lend money or otherwise invest in a portfolio company in the future without condition are within the definition's reach. This would address the unique types of

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[10] Proposed Rule at 59.

[11] *Id.* at 322.

[12] *Id.* at 413; Proposed Rule 18f-4(b)(1).

financing provided by BDCs and ensure that the requirement to maintain qualifying coverage assets does not render certain financing structures impracticable or inefficient to the detriment of the portfolio companies to which BDCs provide financing, as well as the BDCs and their shareholders.

a. The Commission Should Clarify the Definition of a Financial Commitment Transaction in Regard to Unfunded Commitments

As an illustration of the concerns presented by the "financial commitment transaction" definition in the Proposed Rule, it is helpful to provide more context to the types of lending relationships engaged in by BDCs. Many BDCs, particularly those operating in the lower middle market, provide revolving loan facilities ("Revolvers") to small and mid-size businesses, which are critical sources of capital for these businesses for seasonal needs or near term expansion. Often, these Revolvers are authorized for an amount far in excess of that borrowed, or the lines are never utilized by the business. These Revolvers may entice borrowers to enter into other financing transactions with BDCs, such as term loans.

Under the definition of financial commitment transaction in the Proposed Rule, BDCs will now be required to treat all undrawn amounts under Revolvers as "financial commitment transactions" subject to the portfolio limitations, as they will be considered "unfunded commitments."[13] To illustrate the significance of these transactions to BDCs, a Division of Economic & Risk Analysis ("DERA") white paper on the use of derivatives and financial commitment transactions ("DERA White Paper") noted that financial commitment transactions were made by 80% of the BDCs in their sample.[14]

The terms of a Revolver or other type of financing facility made available by a BDC to a portfolio company can vary depending on the BDC and the structure of the facility. The varying terms of these "unfunded commitments" and financing facilities matter, including whether the terms include the right of the BDC to participate in future funding of the portfolio company, whether there are liquidation preferences included in the terms, whether the BDC has preemptive and anti-dilutive rights and other covenants, financial metrics and conditions that may determine whether the BDC is required to deliver on its "unfunded commitment." Often, a BDC may have negotiated the ability to opt out of making a particular loan, such as with "consent rights", or if a company has not reached certain performance benchmarks. The Proposed Rule fails to recognize these differences, and should be clarified and narrowed to address conditional lending by BDCs.

[13] Proposed Rule at 58-59.

[14] *White Paper: Use of Derivatives by Registered Investment Companies*, SEC Division of Economic & Risk Analysis (2015), p. 14, *available at:* https://www.sec.gov/dera/staff-papers/white-papers/derivatives12-2015.pdf

b. Release 10666 Did Not Contemplate Non-Conditional Agreements, such as Conditional Unfunded Commitments to BDC Portfolio Companies

Release 10666, while released prior to the authorization of BDCs in 1980,[15] has only recently begun to be applied to BDCs by the Commission staff, particularly in regard to unfunded commitments. The Proposed Rule appears to seek to return to the principles of Release 10666. Release 10666 was focused on, and concerned with certain practices engaged in by ’40 Act funds that the Commission staff believed “involve[d] the issuance of senior securities” and were “prohibited by, or subject to the asset coverage requirement of section 18(f)(1) or the ’40 Act.[16] In particular, Release 10666 looked at the following practices: reverse repurchase agreements, firm commitment agreements and standby commitment agreements.[17] The latter two agreements are most applicable to the unfunded commitment discussion. These practices were focused on speculative betting interest rates and credit risks, rather than financing businesses. Revolvers imposing conditions on borrowing, and similar financing facilities, do not exhibit the speculative characteristics of the firm and standby commitment agreements targeted in Release 10666.

The commitments highlighted in Release 10666 were *non-conditional* agreements to buy from a broker-dealer 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 long-term debt security paying a fixed rate. As a result, these ’40 Act funds were subjecting themselves to unconditional interest rate risk, the credit risk of the issuer, and the credit risk of the counterparty. These types of agreements, or “senior securities” under Release 10666, created a significant risk of loss to the fund, similar to leverage, and were extremely speculative.

In contrast, certain unfunded commitments made by BDCs, such as Revolvers with conditions for receiving financing as highlighted above, are conditional, have low credit and interest rate risk for the BDC, and no counterparty risk (until they are funded). In this context, the BDC sets the terms of the financing commitment, and can impose limitations on its requirement to deliver financing to the portfolio company, which is very different from the non-conditional agreements discussed in Release 10666. The Commission should recognize these differences as it revisits the financial commitment transaction definition in the differing context of BDC financing facilities.

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[15] Securities Trading Practices of Registered Investment Companies, 44 Fed. Reg. 25128-25134 (April 27, 1979); SEC Release No. IC-10666.

[16] *Id.* at 25128.

[17] *Id.*

c. Imposing the Proposed Rule Without Adjustments will Limit Access to Capital for Small and Mid-Size U.S. Businesses

Application of the Proposed Rule without adjustment to the definition of a financial commitment transaction will significantly limit the ability of small and mid-size U.S. businesses to access on-demand financing from BDCs. The Proposed Rule will make BDCs' extension of certain financing facilities to these firms economically unfeasible. As such, the impact of the Proposed Rule flies in the face of the original purpose of BDCs, which is to provide greater access to financing and managerial expertise for small and mid-sized firms that create jobs and drive economic growth in the United States.

There is a strong policy argument for revisiting the definition of a financial commitment transaction. Requiring BDCs to set aside qualifying coverage assets equal to at least 100% of their unfunded commitments and other obligations under financial commitment transactions will make it less likely that BDCs will be able to extend Revolvers and other critical financing facilities to small and mid-size businesses in the United States. Even if BDCs can continue providing such financing facilities, they will be much more costly for businesses to receive and will likely be smaller in size, as BDCs will be required to dedicate a significant portion of their assets to maintaining the newly required level of qualifying coverage assets. Higher-cost and smaller financing facilities will harm domestic businesses relying on the capital provided by BDCs, particularly with traditional banking institutions retreating from this lending space. Businesses may continue to have lending relationships with BDCs, but they may lose the certainty of a committed Revolver to fund ongoing operations and bridge liquidity needs. As a result, the Commission should tread carefully and ensure that critical capital can continue to flow from BDCs to U.S. businesses.

In sum, the Commission's staff should craft a more nuanced definition of a financial commitment transaction in any final rule. SBIA encourages the staff to engage in a dialogue with our members to better understand the impact the Proposed Rule and its definition of a financial commitment transaction would have on BDCs, which will assist the staff in crafting suitable language that takes into account the varying terms and structures of financing facilities commonly provided by BDCs. This approach will help ensure that investors are protected against any risks presented by these transactions, without curtailing BDCs' ability to provide financing to small and mid-size U.S. companies, burdening BDCs with unnecessary asset segregation nor imposing increased costs of financing on BDC portfolio companies. This segregation of assets actually harms shareholders by reducing the cash available for distribution by BDCs, which are required to distribute over 90% of their cash.

III. The Definition of Qualifying Coverage Assets Should Be Expanded to Provide More Flexibility for BDCs

The Proposed Rule requires that funds engaged in financial commitment transactions set aside cash or cash equivalents, or assets that are "convertible to cash or that will generate cash, equal in amount to the financial commitment obligation, prior to the date on which the fund can be expected to be required to pay such obligation…"[18] This definition will require BDCs to set aside significant sums of capital to cover "unfunded commitments," capital that could be invested in small and mid-size U.S. businesses in accordance with BDCs' congressional mandate. Due to their unique business model and in accordance with prior SEC policy, BDCs should be able to use other means beyond cash and cash equivalents to cover financial commitment transactions, including unfunded commitments.

Many BDCs utilize financing facilities under which they have a secured credit line with a traditional banking institution. These financing facilities are provided by banks to BDCs based on the creditworthiness of the BDC and pursuant to the contractual commitments the BDC enters into with its lender(s). The SEC should permit a BDC to count amounts available to be borrowed under a BDC's financing facilities as qualifying coverage assets eligible for segregation against the BDC's financial commitment obligations. This would reduce the financial burden imposed on BDCs in maintaining capital for unfunded commitments and result in less harm on investor returns,[19] as well as domestic businesses seeking to access financing from BDCs. This would also retain the level of investor protection that currently exists within the framework of the existing asset coverage requirements of the '40 Act.

Moreover, there is Commission precedent for the utilization of lines of credit to manage liquidity risk in '40 Act funds. In SEC proposed rule 22e-4,[20] the Commission explicitly recognized that "it was relatively common for funds to establish lines of credit to manage liquidity risk, and that funds may use borrowed money or draw on other funding sources to meet shareholder redemptions, typically during periods of significantly limited market liquidity."[21] In the same proposed rule, the Commission provided guidance for funds using these tools, suggesting that

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[18] Proposed Rule at 416-417; Proposed Rule 18f-4(c)(8).

[19] We note, however, that maintaining availability under its financing facilities typically would not be without cost to a BDC because lenders typically charge a fee on undrawn amounts under financing facilities. While less costly than interest in drawn amounts, such undrawn fees are not insignificant.

[20] SEC File Nos. S7-16-15; S7-08-15, Open-End Fund Liquidity Risk Management Program; Swing Pricing; Re-opening of Comment Period for Investment Company Reporting Modernization Release, (September 22, 2015) at 163.

[21] *Id.*

they are appropriate for addressing the specific concerns about fund liquidity the Commission is raising in the Proposed Rule in regard to covering financial commitment transactions.[22] SBIA encourages the Commission to allow BDCs to count the availability under their financing facilities as qualifying coverage assets for financial commitment transactions.

In addition to permitting the use of a BDC's credit facility as a qualified coverage asset, the Proposed Rule should provide additional clarification that liquid investments, as determined by the BDC's board of directors, are available for use as a qualifying coverage asset as well. This clarification should be subject to the extent these assets can be liquidated in a secondary market, as determined by the BDC's board, regardless of maturity or coupon.

IV. BDCs Should be Permitted to Treat An Asset It Will Receive Once a Loan is Funded as a Fund Asset for Asset Coverage Calculation Purposes

The Proposed Rule is structured as an exemptive rule from the requirements of Sections 18 and 61 of the 1940 Act, and if adopted as proposed, it could be interpreted to require, with respect to BDCs that do not rely on the exemption provided by the Proposed Rule, the inclusion of derivatives and financial commitment transactions (including a BDC's unfunded loan commitments if they remain within the definition) as senior securities issued by the BDC when calculating the asset coverage tests in Sections 61(a)(1) (applicable to indebtedness) and 18(a)(2) (applicable to preferred stock) of the 1940 Act. The same would be true for the asset coverage tests in Section 18(a) applicable to closed-end RICs and the asset coverage test in Section 18(f) applicable to open-end RICs. If such an interpretation were adopted and unfunded loan commitments were considered senior securities for purposes of the definition in Section 18(g), funds should be permitted to treat the asset that a fund will receive once the loan is funded as an asset of the fund for purposes of calculating the asset coverage tests set forth in Section 18(h) of the 1940 Act.

BDCs typically calculate their asset coverage ratios using the definition of "liability" under accounting principles generally accepted in the United States ("GAAP"). Unfunded loan commitments are contingent operating obligations that are not treated as liabilities for accounting purposes. As discussed above, BDCs are not required to provide funding under the terms of these commitments unless certain conditions are met; therefore, the obligation to fund does not become the BDC's liability unless and until the counterparty satisfies all applicable conditions. BDCs' financial statements are prepared in conformity with GAAP, and as such, the notional amounts of such unfunded loan commitments are not required to be reflected in a BDC's financial statements and only the fair value of such unfunded loan commitments is required to be

[22] *Id.* at 163-164.

reflected (i.e., to the extent that the unfunded loan commitments result in unrealized depreciation, the BDC records a liability and a corresponding unrealized loss). In accordance with GAAP, BDCs disclose contingent obligations comprising unfunded loan commitment in the footnotes to the financial statements.

Further, once an unfunded loan commitment is funded, the fund's financial statements reflect an investment for the drawn loan amount, and the corresponding previously unfunded loan commitment is extinguished. We are not aware of any guidance from the SEC or its staff suggesting that the definition of "asset coverage" under Section 18(h) of the 1940 Act and made applicable to BDCs through Section 61 of the 1940 Act requires that a BDC (or RIC) deviate from GAAP accounting when determining its asset coverage ratio. As such, BDCs should be permitted to treat the asset that a fund will receive once the loan is funded as an asset of the fund for asset coverage test purposes.

V. The Commission Should Preserve Flexibility in the Proposed Rule in Connection with the Asset Coverage Ratio to Adapt to Potential Future Changes

The Proposed Rule requires either an exposure limit of 150% of net assets, based on the DERA White Paper[23]("Exposure Limit"), or a VaR reduction with total exposure not exceeding 300% of the fund's net assets ("Risk Limit"), for funds that engage in senior securities transactions.[24] The few BDCs that utilize derivatives primarily use them for currency and interest rate hedging purposes or other ordinary course of business purposes, rather than speculation. The Proposed Rule does not address the differences between BDCs and other '40 Act funds, and sets the same Exposure Limit and Risk Limit for both. SBIA believes greater clarity is required in regard to the proposed leverage differences, which do not appear to take into account the leverage limitation differences between open-end and closed-end funds and BDCs.

SBIA's understanding is that these elements in the Proposed Rule, for those BDCs that utilize derivatives, would act as a secondary cap on the use of leverage by BDCs, beyond that set forth already in section 61(a)(1) of the '40 Act. This is particularly true, if in the future, the asset coverage ratio in section 61(a)(1) was to be adjusted. SBIA urges the SEC staff to tie any final rule Exposure Limit or Risk Limit methodology to the leverage limits applicable under the '40 Act, with the cap being proportional to the amount of leverage a fund is permitted to utilize.

SBIA would like to be helpful to the SEC staff in explaining the types of transactions that BDCs engage in, and other aspects of their business that would be impacted by the Proposed Rule, particularly in regard to unfunded commitments.

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[23] Proposed Rule at 97.

[24] *Id.* at 91, Proposed Rule 18f-4(a)(1)(i) and (ii).

Please contact SBIA's General Counsel, Christopher Hayes, at [redacted] or [redacted] if we can provide additional assistance on this issue.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance