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March 28, 2016

Via Electronic Mail: rule-comments@sec.gov

Securities and Exchange Commission,
100 F Street NE.,
Washington, DC 20549-1090.

Attention: Brent J. Fields, Secretary

Re: Release No. IC-31933
File No. S7-24-15 [RIN 3235-AL60]

Ladies and Gentlemen:

We are pleased to submit this letter in response to the solicitation by the Securities and Exchange Commission (the "Commission") for comments on proposed rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940 (the "Act"), which would provide for an exemption allowing mutual funds, exchange-traded funds, closed-end funds and companies that have elected to be treated as business development companies under the Act ("BDCs" and, collectively, "Covered Funds") to enter into derivatives transactions and financial commitment transactions (as those terms are defined in the Proposed Rule) notwithstanding the restrictions on the issuance of "senior securities" under Section 18 of the Act.[1]

We respectfully request that the Commission consider the following recommendations for changes to the Proposed Rule that will ultimately be adopted (the "Final Rule").

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1 Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed Reg. 80883 (December 28, 2015).

1. **The Proposed Rule should be narrowly tailored to exclude certain contingent obligations of Covered Funds.**

The scope of the proposed exemption and the related requirements is tied to the definition of financial commitment transactions: "any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement or similar agreement." For this purpose, the Proposed Rule identifies a "similar agreement" as 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." The Proposed Rule would require a Covered Fund that chooses to enter into a financial commitment transaction in reliance on the proposed exemption to simultaneously set aside and maintain "qualifying coverage assets" equal in value to the full amount that the fund is conditionally or unconditionally obligated to pay under the terms of such transaction.[2] A Covered Fund's use of financial commitment transactions in reliance on the exemption would also be subject to a portfolio-level limit (together with its "derivatives transactions," as defined in the Proposed Rule, and senior securities entered into pursuant to Section 18 of the Act without regard to the exemption provided by proposed Rule 18f-4) and various other requirements. Moreover, a Covered Fund's board of directors would be required to adopt and oversee policies and procedures governing that Covered Fund's use of financial commitment transactions in reliance on the Proposed Rule, including specific policies "reasonably designed to provide for the fund's maintenance of qualifying coverage assets."

We are concerned that the proposed definition of "financial commitment transaction" may include transactions that do not raise any of the concerns the Proposed Rule intends to address. For instance, the Proposed Rule's definition of financial commitment transactions includes *conditional* obligations to make a loan or equity investment even if the condition is entirely within the control of the Covered Fund. By including such conditional obligations within the scope of the proposed exemption from Section 18, the Proposed Rule implies that these conditional obligations constitute senior securities for purposes of Section 18.

We understand that the Commission's intention in including conditional obligations of a Covered Fund, as described in the Proposing Release, was to capture contingent liabilities such as standby commitment letters, which, though conditional, can materialize upon the occurrence of conditions beyond the control of the Covered Fund providing the financial commitment. But read literally, the Proposed Rule's definition of "financial commitment transaction" includes an agreement providing for conditional obligations where the satisfaction of the condition, or the determination of whether a condition has been satisfied, is within the sole control, or at the sole discretion, of the Covered Fund. Consider a Covered Fund that enters into an agreement obligating the Covered Fund to loan money at a future date, conditional on the borrower's business

2 Proposed rule 18f-4(b)(1)

prospects evidencing an ability to repay the loan, the determination of which rests exclusively with the Covered Fund at its discretion. In this example, whether the Covered Fund's conditional obligation will actually materialize into a payment obligation is entirely within the control of the Covered Fund, which is categorically different from obligations under a standby commitment letter or other instrument which depend on a condition *outside* the control of the Covered Fund.

Treating conditional obligations that are within the control of a Covered Fund as financial commitment transactions would put BDCs at a competitive disadvantage to banks in seeking to make loans to small and medium-sized companies. The Proposed Rule would require a BDC to set aside qualifying coverage assets to cover the entire amount of any unfunded commitments (or to treat such amount as a senior security), and would cap the amount of such commitments, together with any other financial commitment obligations, at 100% of net assets. As a result, the Proposed Rule would raise the capital costs of BDCs for providing such commitments and put them at a competitive disadvantage to banks, which are not required to take any regulatory capital charge for the unfunded portion of their "unconditionally cancelable" commitments.[3]

Moreover, the proposed definition as drafted appears to capture, presumably inadvertently, non-binding term sheets and other preliminary transaction documents that represent merely an "agreement to agree." Because such agreements typically include a promise to lend or purchase upon the occurrence of certain conditions, including the execution of a binding definitive agreement incorporating the terms of a term sheet in a form acceptable to the parties, under a literal interpretation of the Proposed Rule, a non-binding "agreement to agree" could be classified as a financial commitment transaction, triggering the rule's requirements. We believe that such "non-agreements" should not be considered senior securities for purposes of Section 18 and that they were not intended by the Commission to be so considered. Non-binding term sheets do not impose contingent obligations that may occur *without the future agreement* of the parties. They are fundamentally different from the types of financial commitment transactions discussed in the proposing release, and do not create the risks the rule is designed to guard against.

For the foregoing reasons, we request that the Commission clarify in the text of the Final Rule, if adopted, that contingent obligations that are subject to conditions the satisfaction of which is within the sole control of the Covered Fund and independent

3 Banks are permitted to apply a credit conversion factor of zero to unconditionally cancelable commitments, which has the effect of not requiring a regulatory capital charge. We note that the Basel Committee on Banking Supervision is reviewing credit conversion factors applicable to the unused portion of unconditionally cancelable commitments for purposes of the Basel framework's standardized approach to credit risk.

of any standard or the approval of any other party, will not be considered senior securities subject to Section 18 of the Act or "financial commitment transactions," subject to the requirements of the Final Rule. This could be accomplished by revising Section 18f-4(c)(4) of the Proposed Rule to read "...including by making a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner; *provided that no agreement under which the fund's obligations are contingent on a condition the satisfaction of which is within the fund's sole control, or for which the determination of whether such condition has been satisfied is to be made by the fund, in its sole discretion, shall be considered a financial commitment transaction, nor shall the fund's entry into such agreements be considered an issuance of senior securities subject to the prohibitions of Section 18(a)(1) (15 U.S.C. 80a-18(a)(1)), Section 18(c) (15 U.S.C. 80a-18(c)), Section 18(f)(1) (15 U.S.C. 80a-18(f)(1)) and Section 61 (15 U.S.C. 80a-61) of the Investment Company Act*." In addition, we request that the Commission clarify in the adopting release for the Final Rule that non-binding term sheets, other preliminary transaction documents and other "agreements to agree" will not be considered subject to the limitations of Section 18 of the Act, nor should they be subject to the Final Rule's requirements for financial commitment transactions (or, alternatively, that the Final Rule specifically address this point).

2. **The Proposed Rule should provide BDCs with greater flexibility to enter into senior securities transactions than other Covered Funds, consistent with Congress's intent in enacting Section 61 of the Act.**

In addition, we are concerned that by failing to differentiate between BDCs and registered investment companies, the Proposed Rule would unduly interfere with the intended function of BDCs as a source of capital for small and medium-sized United States businesses. In enacting Section 61 of the Act, Congress intentionally provided BDCs with a greater ability to incur leverage beyond that permitted to registered investment companies. In particular, BDCs are subject to a 200% asset coverage requirement for any senior securities issued, as opposed to the 300% asset coverage requirement applicable to closed end funds and the prohibition on open end funds offering any Section 18 senior securities whatsoever. By permitting the organization of BDCs, Congress recognized the critical importance of small and medium-sized businesses to the American economic system in terms of innovation, productivity, increased competition and job creation, and intended to incentivize the provision of capital to such businesses by removing unnecessary and burdensome regulatory obstacles.[4] Unlike registered funds, which typically invest in a broad range of relatively liquid securities (and are subject to a 15% limit on investments in illiquid securities

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4 *See generally* House of Representatives Report, Interstate and Foreign Commerce Committee, 96-1341, H.R. Rep. No. 1341, 96th Cong., 2nd Sess. (Noting that the bill addresses a recent "slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses" which are of primary importance to the "American economic system in terms of innovation, productivity, increased competition and the jobs they create...").

pursuant to the Commission's longstanding position), BDCs are required to make most of their investments in small and medium-sized businesses having their principal place of business in the United States. Permitting BDCs to incur more debt than registered funds lowers the BDC's cost of capital, thereby enabling BDCs to offer lower cost capital to small and medium-sized businesses. In addition, because a significant portion of a BDC's assets will consist of relatively illiquid investments in small and medium-sized businesses, a BDC would typically rely on debt as a source of readily-available capital to a greater extent than other types of funds, which typically have a greater ability to raise cash by selling their liquid holdings.

The Proposed Rule would effectively end the 35 year old policy permitting BDCs greater access to leverage than registered funds, undermining congressional intent. If adopted, BDCs that choose to rely on the Proposed Rule's exemption from Section 18 of the Act would be subject to the same restrictions as registered funds, including open-end funds, with respect to their use of derivatives and reverse repurchase agreements as a potential tool for creating liquidity. While BDCs have not historically used such instruments to the same extent as mutual funds, as financial markets continue to evolve, such instruments may become more attractive sources of short-term financing to BDCs. BDCs should have a greater ability to engage in such transactions than other types of funds, consistent with Sections 18 and 61 of the Act. The fact that BDCs do not now typically use such transactions to a significant extent should not affect the statutory policy granting BDCs greater access to leverage, whatever form it may take.

In addition, we believe that by including unfunded commitments to extend credit within the proposed definition of financial commitment transaction, the Proposed Rule has a disproportionate and adverse impact on the ability of BDCs to fulfill their mandate in comparison to the impact on registered funds. Unlike most mutual funds, BDCs utilize unfunded commitments (such as commitments to make term loans or to provide a revolving line of credit) in the ordinary course of their business.

Requiring BDCs to set aside a dollar of liquid assets for every dollar of unfunded credit commitments runs contrary to congressional intent. Not only would this reduce the supply of capital to small and medium-sized businesses in contravention of statutory policy, it would also fail to differentiate between unfunded credit commitments, on the one hand, and other types of "financial commitment transactions" utilized by non-BDC funds, such as short sale borrowings and repurchase agreements, that carry far greater risks, on the other. Unlike short sale borrowings, for instance, an unfunded commitment to extend credit does not expose a BDC to the risk of unlimited losses. Furthermore, a BDC's purpose for entering into an unfunded commitment is not to benefit from the change in price on an underlying security with the hope of achieving an "in-the-money" outcome; on the contrary, BDCs typically earn a regular rate of interest to the extent that the commitment is utilized. In this way, unfunded commitments as utilized by many BDCs do not reflect the concerns raised by Congress in the Act or those raised by the Commission in the proposing release (or previously in Release 10666).[5]

The proposing release notes further that the Proposed Rule would not restrict the ability of a BDC to continue to engage in leveraging transactions pursuant to Section 61 without relying on the Proposed Rule. However, applying the Proposed Rule's logic, even if a BDC elects not to rely on the Proposed Rule's exemption, it would still be deemed to have "senior securities indebtedness" under Section 61 in the amount of its unfunded commitments. As a result, a BDC's unfunded commitments could use up some or all of the BDC's capacity to incur leverage under Section 61's 200% asset coverage test, preventing the BDC from using such capacity for its intended purpose: as a means of generating cash to fund investments in small and medium-sized businesses.

Accordingly, we respectfully suggest that the Final Rule, if adopted, and the related adopting release give effect to congressional intent regarding BDCs. BDCs should have greater flexibility to engage in derivatives and financial commitment transactions under rule 18f-4 than other types of funds. This could be accomplished by (i) increasing the cap on qualifying coverage assets under the Proposed Rule's exemption beyond 100% for BDCs, (ii) reducing the amount of qualifying coverage assets applicable to derivative and financial commitment transactions for a BDC, (iii) treating unfunded commitments to invest in securities identified in paragraphs 1 through 3 of Section 55(a) as qualifying coverage assets, or (iv) excluding unfunded commitments to invest in securities identified in paragraphs 1 through 3 of Section 55(a) from the definition of "financial commitment transaction."

In addition, as part of the Commission's review of Section 18, the Commission should recognize that the position it has taken with respect to standby purchase agreements, and now unfunded commitments, puts such transactions at a significant disadvantage compared to short sales or reverse repurchase agreements. We believe the Commission should take this opportunity to eliminate such disadvantage. Unlike a short sale or a reverse repurchase agreement that results in the fund, as party to such agreement, recognizing an asset (*e.g.*, the cash received for the short sale) under generally accepted accounting principles in the United States ("GAAP"), the fund that enters into an "unfunded commitment" does not acquire a GAAP asset. Nonetheless, the Commission has taken the view, as expressed in Release 10666, that such instruments are "senior securities" under Section 18 and, therefore, impact the asset coverage requirements under Section 18 and Section 61. The effect of this is that the fund entering into an unfunded commitment has a "liability" for purposes of the asset coverage test with no offsetting "asset." We believe that if the Commission continues to treat unfunded commitments as senior securities, then it should allow funds to recognize the "asset" that will be acquired if and when the counterparty to the transaction draws on the

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5 "Securities Trading Practices of Registered Investment Companies," *Investment Company Act Release No. 10666* (Apr. 18, 1979), codified at 44 Federal Register 25128 (Apr. 27, 1979).

unfunded commitment. To be clear, doing so will not have the effect of permitting unlimited unfunded commitments or questioning the long-standing position set forth in Release 10666.[6] It will simply acknowledge the offsetting non-GAAP asset that corresponds to the non-GAAP liability the fund is required to recognize in the form of a senior security.

3. **The Proposed Rule and the adopting release should recognize as assets for purposes of "qualifying coverage assets" and for purposes of Section 18 and Section 61 of the Act cash that is available to a Covered Fund either through equity commitments provided by investors in the Covered Fund or through available borrowing capacity of the Covered Fund.**

Finally, we believe that it is appropriate to allow a Covered Fund to treat as an "asset" for purposes of the definition of "qualifying coverage assets" under the Proposed Rule and for purposes of complying with Section 18 and Section 61 of the Act the amount of cash that a Covered Fund has a contractual right to receive pursuant to an equity commitment or a commitment to extend credit. A Covered Fund's ability to call equity in the form of cash from investors represents an irrevocable funding commitment on the part of an investor in a Covered Fund to pay cash to the Covered Fund on notice from the Covered Fund. For instance, if the Covered Fund has the right to obtain cash from its investors prior to the date on which the Covered Fund expects to be required to pay an obligation under a financial commitment transaction, the Covered Fund should be entitled to treat such right as a "qualifying coverage asset" with respect to such obligation. While a Covered Fund's right to receive capital contributions would not be treated as a traditional "asset" under GAAP for financial reporting purposes, that does not diminish in any way the Covered Fund's contractual right to require the investor to pay cash to be used for any business purpose the Covered Fund deems appropriate. Moreover, recognizing the "asset" in this context is entirely consistent with requiring the Covered Fund to recognize a non-GAAP liability for purposes of Sections 18 and 61 of the Act and addressing the concerns articulated in the proposing release.

Similarly, cash that is available to a Covered Fund through unutilized borrowing capacity (*e.g.*, a loan commitment provided by a bank or other lender that must be funded on notice by the Covered Fund) should also be recognized as an "asset" for purposes of the proposed definition of "qualifying coverage assets" and for purposes of complying with Section 18 and Section 61 of the Act to the extent that the Covered Fund could draw on such capacity without violating the asset coverage limitations on the incurrence of indebtedness set forth in Section 18 and Section 61. A Covered Fund

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6 A fund that recognizes a dollar of senior securities as a result of executing an unfunded commitment would, under this proposal, recognize a dollar of "assets" in respect of the funds that could be advanced pursuant to the unfunded commitment – or 100% "asset coverage." The asset coverage requirement is 300% for a closed end fund and 200% for a business development company.

typically pays a fee for the right to have a lender stand ready to lend funds. So long as the Covered Fund has the right to borrow under the terms of an agreement evidencing a binding commitment, including by satisfying any conditions precedent under the terms of the commitment and any restrictions on borrowing under the Act, we believe the asset should be recognized for purposes of the Proposed Rule and Sections 18 and 61 of the Act. Again, recognizing the "asset" in this context is entirely consistent with requiring the Covered Fund to recognize a non-GAAP liability for purposes of Sections 18 and 61 of the Act and addressing the concerns articulated in the proposing release.

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We appreciate this opportunity to comment on the Proposed Rule, and would be happy to discuss any questions with respect to this letter. Any such questions may be directed to William G. Farrar ([redacted]; [redacted]) or Donald R. Crawshaw ([redacted]; [redacted]).

Very truly yours,

Sullivan & Cromwell LLP

SULLIVAN & CROMWELL LLP