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March 28, 2016

**Via Electronic Delivery:** rule-comments@sec.gov

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: Investment Company Act Release No. IC-31933 (File No. S7-24-15)**

**Use of Derivatives by Investment Companies and Business Development Companies (collectively, "Funds")**

Dear Mr. Fields:

Altegris Advisors, L.L.C. ("**Altegris**") appreciates the opportunity to respond to the U.S. Securities and Exchange Commission's ("**SEC**" or "**Commission**") proposed rule regarding the "Use of Derivatives by Investment Companies and Business Development Companies" (the "**Proposed Rule**").[1] This letter focuses on certain aspects of the Proposed Rule relative to the proposed definition and scope of "financial commitment transactions" in the context of investments by Funds in interests of underlying private equity funds.[2]

Altegris is registered as an investment adviser with the SEC and as a commodity trading advisor and a commodity pool operator with the U.S. Commodity Futures Trading Commission. As of March 1, 2016, Altegris managed approximately $2.32 billion in assets held in public and private funds offered to institutional and individual investors, including open-end Funds, a non-listed closed-end Fund, and a platform of privately-offered hedge funds and commodity pools.

## I. Summary

Altegris generally supports the Commission's undertakings in this Proposed Release and in other current and future rulemakings, to modernize, clarify and provide a more comprehensive approach to the regulation of Funds' use of derivatives and other transactions that raise or may raise "senior securities" issues under Section 18 of the Investment Company Act of 1940 (the "**1940 Act**").

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[1] 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf (the "**Proposing Release**").

[2] Altegris' comments regarding the Proposed Rule relative to the regulation of Funds' use of derivatives, and more particularly the use of derivatives by Funds that offer managed futures strategies, are presented in a separate letter to the Commission being submitted by Dechert LLP (on behalf of Altegris and other investment managers named therein).

However, we are writing to express our concerns with the Proposed Rule in the context of Funds that pursue a principal investment strategy of investments in underlying private equity funds ("**PE Funds**"). As used in this letter, a PE Fund refers to either a privately- or publicly- offered, non-exchange traded, continuously offered, closed-end registered investment company operating as a fund of funds, and which has a stated principal investment policy of investing and committing to invest portfolio assets into underlying private equity funds, over time. Unlike mutual funds that are offered to retail investors, PE Funds, whether offered publicly or privately, are generally not available to retail investors, but rather, are available only to high net worth accredited investors as defined in Regulation D of the Securities Act of 1933 (consistent with long-standing positions of the Commission Staff).

We respectfully disagree with, and urge the Commission to reconsider, its proposal to include within the definition of a financial commitment transaction the "making [of] a capital commitment to a private fund that can be drawn at the discretion of the fund's general partner" (*i.e.,* an "unfunded commitment").

As described below, we strongly believe (i) that unfunded commitments do not expose Funds generally, or PE Funds specifically, to leverage or to possible leveraging effects (*i.e.,* potentially magnifying Fund gains or losses) in a manner that raises senior security issues under Section 18, and (ii) that the proposal to require segregation and maintenance of "qualifying coverage assets", if adopted, would unnecessarily harm PE Fund shareholders by materially increasing the "cash drag"[3] of PE Funds, with resulting negative impacts on shareholders' returns, and be inconsistent with PE Fund shareholder expectations that managers of PE Funds make capital commitments to underlying private equity funds in a manner that minimizes cash drag, to the extent prudent (referred to as a "commitment strategy").

We urge the Commission, in its final rule, not to extend the definition of a financial commitment transaction to include unfunded commitments to private funds made by Funds or PE Funds.

## II. Unfunded Commitments Do Not Raise Senior Security Concerns

In the Proposing Release, the Commission describes its rationale and basis for proposing to require maintenance of qualifying coverage assets for financial commitment transactions as necessary to "address funds' use of the trading practices described in Release 10666, as well as short sales of securities." (*See* Section III.E. of the Proposing Release). In an accompanying footnote, the Commission notes that unfunded commitments are among transactions it views as "similar agreements", although not addressed in Release 10666 and without further analysis in the Proposing Release as to how unfunded commitments are similar to the practices addressed in Release 10666. As discussed below, we believe unfunded commitments are materially dissimilar (in both construct and impact on fund investment portfolios) to the types of transactions described in Release 10666, and therefore their inclusion within the scope of the Proposed Rule's definition of financial commitment transactions is unwarranted.

[3] "Cash drag" refers to the opportunity cost to shareholders of a fund that holds a portion of its investment portfolio in cash or cash equivalents for liquidity purposes or to take advantage of future investment opportunities. *See* Section III below.

Release 10666[4] was an SEC general statement of policy regarding the economic effects and senior security implications under the 1940 Act of instruments including reverse repurchase agreements, firm commitment agreements and standby commitment agreements.[5] Release 10666 discusses the SEC's concerns with these trading practices (and other comparable trading practices) that could have a leveraging effect on a Fund's portfolio that could magnify "the potential for gain or loss on monies invested and, therefore, result in an increase in the speculative character of the investment company's outstanding securities."

In the case of reverse repurchase agreements, the SEC in Release 10666 found such transactions, in economic reality, to be secured loans to a Fund from a third party. As noted in Release 10666, a reverse repurchase agreement could allow a Fund to take the proceeds from the third party and purchase other interest bearing securities, allowing the Fund to derive income from the interest rate differential between the cost of the loan from the third party and the return on the security purchased by the Fund – thereby achieving a leveraged return on its capital base (*i.e.*, on its cash contribution). Release 10666 noted that leverage through a reverse repurchase agreement creates the risk of magnified capital losses if the returns of the purchased securities are less than the costs of entering into the reverse repurchase agreement. In addition, the Release notes that a Fund entering into a reverse repurchase agreement could potentially pyramid the leveraging effect by entering into additional reverse repurchase agreements using the securities purchased with the proceeds of the earlier reverse repurchase agreements. Thus, while the Fund's net assets remain the same, the total risk to Fund shareholders increases commensurate with the increase in gross assets.

Release 10666 also addressed firm commitment agreements, whereby a Fund agrees to purchase a security from a seller at a future date, at a stated price and a fixed yield. A firm commitment agreement creates the potential for profit and loss without any investment because interest rate changes in the market will affect the value of the security to be delivered. Release 10666 characterized a firm commitment agreement as "unlimited leverage" because there is no cash investment by the Fund. In a standby commitment agreement, a Fund will contract to accept delivery of a security (*e.g.,* Ginnie Mae) with a stated price and fixed yield upon exercise of the option by the counterparty, with a commitment fee payable to the Fund. The SEC in Release 10666 observed that a standby commitment in economic reality involves the issuance of a "put" by the Fund, and dependent upon interest rate movements, subjects a Fund and its shareholders to risk of loss well in excess of the commitment fee earned.

In each of the examples cited in Release 10666, the SEC concluded that senior security issues were raised, absent the establishment of and maintenance of coverage assets in segregated accounts, and such coverage was viewed as a practical limit on the amount of "leverage" a fund may take on by assuring the availability of adequate funds to meet the obligations arising from such leveraging activity.

By contrast, unfunded capital commitments made by Funds, and PE Funds specifically, to private funds do not create leverage, nor do they present senior security concerns in any way similar to the transactions, trading practices or agreements described in Release 10666.

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[4] Investment Company Act Release No. 10666 (Apr. 18, 1979).

[5] While Release 10666 discusses certain trading practices of open-end funds, footnote 1 of Release 10666 suggests that these types of trading practices may have similar effects on closed-end funds.

(A) **Unfunded commitments do not expose PE Funds to interest rate or similar market risks**. Changes in interest rates or other benchmarks do not change the amount of capital committed by the PE Fund, nor would they affect the amount of capital contributions to be made by a PE Fund when capital calls are made by an underlying private equity fund.[6] We say "may be required to make" because underlying private equity fund capital commitments may or may not be called in whole or in part by the general partner of an underlying private equity fund. As such, capital commitments are contingent liabilities that do not become liabilities on the PE Fund's balance sheet under U.S. generally accepted account principles ("U.S. GAAP") until the underlying private equity funds send a written capital call letter to the PE Fund (as a limited partner), at which time the PE Fund and other limited partners must fund the requested portion of their respective total capital commitment.

(B) **Unfunded commitments do not have a leveraging effect on a PE Fund's portfolio.** A PE Fund's returns are based solely on the actual capital contributions to underlying private equity funds (and other amounts actually invested in underlying private equity vehicles). PE Fund capital commitments do not magnify PE Fund gains or losses, and therefore, do not increase the "speculative character" of the PE Fund's outstanding securities. PE Fund capital commitments also do not impact the management fees earned by the manager of a PE Fund, which are based on the net assets of the PE Fund.

(C) **Unfunded commitments do not allow for the potential pyramiding of additional investments.** Unlike a reverse repurchase agreement, for example, a PE Fund receives nothing from the underlying private equity funds in return for its capital commitments and, as a result, its gross assets remain unchanged.

In its discussion of the proposed definition of a "financial commitment transaction" (*See* Section III.A. of Proposing Release), the Proposing Release notes certain risks related to unfunded commitments, including that other portfolio assets may need to be liquidated in order to satisfy capital calls, and the risk of default (*i.e.,* breach of the limited partner's obligations to commit capital as set out in the limited partnership agreement) should a capital call not be timely satisfied.

We acknowledge that unfunded commitments pose certain intrinsic investment risks. Should a PE Fund be unable to satisfy its commitment obligation on a timely basis and default on a called capital commitment, the underlying private equity fund, pursuant to its limited partnership agreement, typically has a number of potential remedies. These include possibly a reallocation of the PE Fund's defaulted commitment amount to other limited partners, a reallocation of a portion of the PE Fund's existing interest to the other limited partners as a penalty for the default, the loss of access to future investment opportunities presented by the private equity fund or its manager, among others. Also, the underlying private equity fund could sue the PE Fund for breach of contract, with resulting expenses in

[6] See footnote 12 of Release 10666, where the SEC noted 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 because such commitments "neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage." In the same way, a PE Fund's capital commitments are fixed at the time the PE Fund enters into its subscription agreement with an underlying private equity fund.

defending such a lawsuit. To avoid such a default scenario, the adviser to a PE Fund has varied options to effectively manage its unfunded commitment obligations. As the Commission notes, the PE Fund could seek to sell/assign the interest subject to a capital call to a third party thereby eliminating the obligation, or sell/assign other interests held in order to satisfy the subject capital call. The PE Fund may also borrow under a credit facility (using PE Fund assets as collateral) to satisfy a capital call, and if so, such loan or drawdown of credit will constitute a senior security under Section 18, subject to the requirement to maintain 300% asset coverage pursuant to Section 18(h) of the 1940 Act.

None of the above risks, actions or outcomes connected with the making and executing of unfunded commitments (other than, if applicable, a borrowing to satisfy a capital call) constitutes a "senior security" under Section 18, or creates any actual or potential leveraging effect, and shares none of the characteristics and risks of the transactions and trading practices that create a "leveraging effect" and addressed in Release 10666. Therefore, we believe the inclusion of unfunded commitments within the scope of the final rule's definition of a financial commitment transaction is both unnecessary and unwarranted under Section 18 of the 1940 Act and per the guidance in Release 10666.

## III. Maintenance of Qualifying Coverage Assets for Unfunded Commitments Would Harm PE Fund Shareholders

It is important to bear in mind that the management of unfunded commitments so as to minimize cash drag is a key component of the commitment strategies implemented by advisers on behalf of PE Funds, a material basis upon which PE Fund shareholders have invested in PE Funds, and a key factor for which shareholders rely on advisers to PE Funds for anticipated returns on investment from private equity over time.

An effective commitment strategy implemented by an adviser to a PE Fund entails managing capital calls, periodic share repurchases and other liquidity needs through investing in a combination of initial or seasoned primary,[7] secondary[8] and co-investment[9] opportunities and through over-commitments (as described below) to minimize "cash drag" on PE Fund returns. "Cash drag" refers to the opportunity cost of a fund holding a portion of its investment portfolio, un-invested, in cash, or

[7] Primary investments, or "primaries," refer to investments in newly established private equity funds which have not yet begun operation. Primary investments are made during an initial fundraising period in the form of capital commitments, which are then called down by the fund and utilized to finance its investments in portfolio companies during a predefined period. A private equity fund's net asset value will typically exhibit a "J curve," undergoing a modest decline in the early portion of the fund's lifecycle as investment-related expenses and fees accrue prior to the realization of investment gains from portfolio companies, with the trend typically reversing in the later portion of the fund's lifecycle as portfolio companies are sold and gains from investments are realized and distributed. Seasoned primaries are primary fund investments made after a private equity fund has already invested a certain percentage of its capital commitments. As such investments are made later in a private equity fund's lifecycle than standard primaries, they may result in earlier receipt of distributions. Seasoned primaries may be utilized to gain exposure to underlying private equity funds and strategies that would otherwise be unavailable for primary investment and may allow a PE Fund to deploy capital more rapidly.

[8] Secondary investments, or "secondaries," refer to investments in existing private equity funds through the acquisition of an existing interest in a private equity fund by one investor from another in a negotiated transaction. In so doing, the buyer will agree to take on future commitment funding obligations in exchange for future returns and distributions. Secondaries are generally made after a private equity fund has deployed capital into portfolio companies and are viewed as more mature, as such may not exhibit the initial decline in net asset value associated with primary investments and may reduce the impact of the J-curve associated with private equity investing.

[9] Co-investment opportunities involve a PE Fund directly acquiring an interest in an operating company through an investment partnership/vehicle that invests alongside an operating company investment by a private equity fund.

invested in cash equivalents or other liquid securities, to either provide liquidity to shareholders or take advantage of future investment opportunities.

To achieve the stated investment strategies of a PE Fund, the PE Fund's adviser must manage the PE Fund's commitment strategy with a view towards balancing liquidity while maintaining a high level of investment. Primary commitments to private equity funds generally are not immediately deployed. Instead, committed amounts are drawn down by private equity funds and invested over time, as underlying investments are identified, which may take a period of several years. During this time, investments made early in a private equity fund's lifecycle are often realized (generating distributions), and this may occur even prior to a fund's committed capital being fully drawn. As a result, without an appropriate commitment strategy a significant investment position could be difficult to achieve. PE Funds seek to address this challenge by, among other strategies, over-committing to underlying private equity funds and, in their early years, investing more materially in secondaries and co-investments (transactions in which capital is largely deployed at the time of investment) in order to provide an appropriate investment level. The PE Funds will retain cash, cash equivalents or have available credit via a credit facility in sufficient amounts to satisfy capital calls from underlying private equity funds, or meet other liquidity needs.

A PE Fund's commitment strategy aims to keep the PE Fund substantially invested and to minimize cash drag where possible by making commitments based on anticipated future distributions from investments. The commitment strategy will also take other anticipated cash flows into account, such as those relating to new subscriptions, periodic share repurchases and distributions made to shareholders. This requires advisers to PE Funds to effectively forecast portfolio cash flows (typically using proprietary models that incorporate historical data, actual portfolio observations, and insights from underlying private equity fund managers.)

We believe that the commitment of future capital to private equity investment opportunities, through a managed commitment strategy as described above, neither creates a senior security under Section 18, nor introduces any leveraging effect similar to the transactions addressed by Release 10666 (for the reasons as set forth in Section II above). The Proposed Rule's definition of financial commitment transaction, if adopted as proposed, would subject PE Funds to what we view as an unnecessary requirement to segregate and maintain qualifying coverage assets (*i.e.,* cash, cash equivalents and certain liquid securities), in an amount equaling the total amount of a PE Fund's unfunded capital commitments at all times (without regard to the fact such commitments may or may not ever be called, or may not be called for several years).

More critically, the proposal to include unfunded commitments as among the transactions for which segregation and maintenance of coverage assets is required, will thwart the implementation of effective commitment strategies essential to the management of PE Funds. It will significantly increase cash drag in PE Fund investment portfolios, and in turn hamper shareholders' ability to fully realize returns on private equity investments – without corresponding benefit. Further, it would severely curtail PE Funds' access to early-stage primary and co-investment opportunities – a critical source of long-term capital appreciation and upside potential for private equity strategies– and likely increase portfolio risks to PE Fund shareholders as PE Fund advisers are forced to concentrate investment efforts in secondary private equity investment opportunities to achieve investment goals. As the market for secondary investments can be very limited in terms of the scope of strategies and opportunities available at any given time, we believe PE Funds, in an effort to limit the cash drag created by the Commission's proposed coverage requirements, will avoid primary investment and other early stage investment opportunities having significant unfunded commitments and will instead include in their portfolios riskier, distressed or lower-tier secondary investment opportunities than would otherwise have been the case – ***a result that we believe is not intended by the Commission in its Proposed Rule.***

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Thank you for considering our views on this important topic. If you have any questions. or if we can provide any additional information that may assist the Commission and its Staff, please contact David Mathews at [redacted] or [redacted].

Respectfully submitted,

David P. Mathews
General Counsel
Altegris Advisors, L.L.C.