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COMPETITIVENESS

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March 28, 2016

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

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

Dear Mr. Fields:

The U.S. Chamber of Commerce (the "Chamber") created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.[1] The CCMC appreciates the opportunity to comment on proposed Rule 18f-4 (the "Proposed Rule"), which modifies the regulatory regime governing the use of derivatives by registered investment companies ("RICs") and business development companies ("BDCs" and, together with RICs, "funds").

We generally support the Securities and Exchange Commission's (the "Commission") goal of updating the derivatives regulatory regime applicable to RICs and BDCs under Section 18 of the Investment Company Act of 1940 (the "1940 Act"). Indeed, it is entirely appropriate for the Commission to address these issues as the sole agency with the requisite ability to balance the tripartite mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation. Attempts by other regulators to regulate how RICs and BDCs may use derivatives would inappropriately encroach on the Commission's jurisdiction and result in proposals that lack the benefit of the Commission's expertise.

However, we have serious concerns with respect to the new limits being contemplated on the use of derivatives and financial commitment transactions and the

[1] The Chamber is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information.

limits' ultimate impact on capital formation. Simply put, for many different types of funds, the Proposed Rule is completely unworkable[2] and will force them to (1) charge investors more, given the substantially higher amount of capital that must be held when using derivatives; (2) fundamentally restructure their investment strategies; or (3) deregister and either exit the market completely or reorganize as private funds. The Proposed Rule will also impose new and potentially unreasonable requirements on board members in assessing whether a fund is in compliance with proposed rule 18f-4.

Our comments below outline our concerns relating to the portfolio limitation, segregation of assets, and derivatives risk management program requirements of the Proposed Rule. We believe that it is critically important that the Commission address these issues effectively and develop a rule that properly balances the important role that RICs and BDCs play in capital formation with investor protection, especially after conducting a more rigorous economic analysis on how funds use derivatives.

Background and General Comments

As the Commission proceeds with this rulemaking, it is critically important to recognize the role of the mutual fund industry in the American economy. According to the Investment Company Institute, RICs managed $18.2 trillion in assets at year-end 2014 on behalf of more than 90 million investors.[3] RICs, BDCs, and asset management companies also play an important role in the U.S. retirement system. BDCs are also a growing and increasingly important facilitator of corporate formation for businesses. They help channel the wealth of savers through the capital markets, ensuring its productive use and fostering economic growth.

Our economy benefits from the wide variety of funds available to investors today. Mutual funds invest in hundreds of securities and provide investors with the benefit of broad diversification while reducing an individual's aggregate risk exposure. The fund

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[2] We incorporate by reference the study conducted by the Investment Company Institute on the impact of portfolio limits on RICs, contained in Appendix A of their comment letter on the Proposed Rule. As discussed later in our comment letter, the study improves upon the economic analysis released by the Commission in the Proposed Rule, reporting on the impact of the portfolio limits and provides information on 6,661 funds with a total of $13.6 trillion in assets under management as of year-end 2015. According to their analysis, at least 369 funds, with $458 billion in assets under management, either will have to deregister or substantially change their investment strategies to continue their businesses as registered funds.

[3] Investment Company Institute, 2015 Investment Company Fact Book, *available at* http://www.icifactbook.org/fb_ch1.html.

industry's diversity means that funds will also employ different trading strategies to reach their investment objectives. This may include the use of derivatives to reduce potential risk or deliver investment performance by gaining additional exposure.

With these benefits, it is also important to recognize that funds are among the most highly regulated entities in the financial industry. Broadly, the 1940 Act requires funds to "cover" their derivatives exposure by maintaining a segregated account of liquid assets or entering into offsetting transactions. These requirements have effectively limited the use of derivatives by funds while permitting them the flexibility to structure their investment objectives as intended.

We should also recognize the important benefits that derivatives provide to funds, their investors, and the broader capital markets. Funds can use derivatives to hedge their own risk in a number of different ways, ranging from liquidity risk to currency risk, which helps preserve the economic return sought by investors. Importantly, derivatives can be used to gain or lower exposure quickly and cheaply where it may be slow or costly to do so by purchasing or selling individual securities. This added liquidity inures to the benefit of the market and the U.S. economy by permitting continued investment by funds and access to capital for companies through the public markets.

The Chamber also recognizes that other federal agencies, including the Treasury Department and the Financial Stability Oversight Council, are focusing on "perceived fault lines" in the fund industry, particularly with respect to "mutual funds that offer daily redemption to their investors but invest in less-liquid assets."[4] We are concerned that this focus is now evident in the Proposed Rule, as the Proposed Rule appears to specifically target this category of investment companies, including registered managed futures funds, leveraged exchange-traded funds, and other types of "alternative" funds. If enacted as proposed, the Proposed Rule has the very real potential to eliminate entire categories of investment companies that are commonly available to investors today through 401(k) accounts and other savings vehicles, and which help spur additional economic growth through the capital markets.

Therefore, for the reasons set out below, the CCMC believes that the Proposed Rule will significantly harm the ability of funds to manage their risks or gain appropriate exposure through the use of derivatives. We believe that adopting the types of limits set

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[4] *See* Remarks by Counselor Antonio Weiss at the U.S. Chamber of Commerce Capital Markets Summit, Mar. 16, 2016, *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0384.aspx.

out in the Proposed Rule would force many of these funds to deregister, leaving them with the Hobbesian choice of going out of business or moving into different regulatory regimes (thereby eliminating their availability to most investors). Our concerns are listed in more detail below.

Portfolio Limitations

Under the Proposed Rule, a fund cannot exceed an "exposure-based limit" or a "risk-based limit" on derivatives use. The exposure-based limit requires a fund to limit its aggregate exposure to derivatives transactions to 150 percent of a fund's net assets, based on an aggregate notional test. The risk-based limit permits a fund to obtain exposure up to 300 percent of a fund's net assets if the fund also satisfies a value-at-risk ("VaR") analysis.

Using the notional value as the reference for the exposure-based limit is an exceedingly blunt method of measuring potential risk posed by a fund's derivatives holdings. While it is administratively "easy" to use a notional test, that metric does not accurately measure potential risk profiles, particularly amongst different types of derivatives. The risk profile of an interest rate swap, for example, can differ dramatically from the risk profile of a credit default swap, even if they both have the same notional value. Additionally, different derivatives often offset risk to one another, but a test that uses notional value will be treated as having greater risk when calculating the risk exposure of these derivatives when those derivatives cannot satisfy the netting provisions of the Proposed Rule.

The "risk-based limit" also does not appear to be useful when a fund elects to use it rather than the exposure-based limit. This is because of the requirement that a fund's full portfolio VaR be less than a fund's securities VaR after entering into senior securities transactions. This test essentially requires that the entire derivatives portfolio be risk reducing when the exposure-based limit is exceeded. Consequently, the utility of the risk-based limit is significantly diminished in situations where a fund cannot use the exposure-based limit.

As the Commission moves forward with the Proposed Rule, we recommend examining alternative methods of measuring the potential risk of a fund's derivatives portfolio. Raising the 150% exposure-based limit and discounting notional derivatives exposure on the basis of the underlying assets are possible alternatives. Ultimately, the test used to measure exposure should be risk-sensitive and recognize differences in risk levels across asset classes, particularly when considering duration differences among asset classes. The Commission should also examine the Commodity Future Trading Commission's ("CFTC") recently finalized rule on margin requirements for uncleared swaps or the joint CFTC-SEC registration rules for swap dealers, security-based swap dealers, major swap participants, and major security-based swap participants when developing its portfolio limitation requirements.

Segregation of Assets

We also have strong concerns with respect to the asset segregation requirements of proposed rule 18f-4, particularly with respect to what types of assets qualify under the Proposed Rule for derivatives and financial commitment transactions and the calculation of a risk-based coverage amount.

The Proposed Rule would generally only permit cash and cash equivalents to count towards a fund's qualifying coverage assets for derivatives, rather than permitting any liquid securities to qualify. Consequently, many funds will suffer performance issues as a result of not being fully invested in underlying securities. Moreover, the limitation to cash and cash equivalents will be a significant issue for many funds, particularly as demand for holding cash and cash equivalents is being driven by many other reforms at the same time, including money market mutual fund reform.

With respect to financial commitment transactions, the Proposed Rule permits a qualifying coverage asset to consist of "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 the obligation." This is in addition to cash and cash equivalents and other assets that may be delivered or pledged to fulfill a fund's obligations. However, it is unclear from the text of the Proposed Rule whether "assets that are convertible to cash" also encompasses fund securities or other assets that may be sold. We respectfully request the Proposed Rule clarify that fund securities, as well as any fund asset that can be sold regardless of its maturity date or coupon, may be used as qualifying coverage assets for financial commitment transactions.

We also believe that, given the fact that unfunded commitments in private equity funds acquired in the secondary market are not typically called in full, the asset segregation requirements of the Proposed Rule should not apply to such financial commitment transactions.[5]

We also believe that the Commission can again look to the CFTC's initial and variation margin rules in determining whether other highly liquid assets, regardless of maturity date or coupon, can qualify under the Proposed Rule, including the use of "haircuts" for such instruments when appropriate. This will allow funds to use a broad range of qualifying coverage assets consistent with a fund's investment strategy and without the same penalty to investment performance associated with holding cash and cash equivalents.

The risk-based capital buffer also presents unique challenges to fund boards in that it requires the board to interpret "stressed conditions" and whether a buffer is appropriately calibrated to withstand such periods of distress. The lack of clarity on how a board would determine the appropriate size of a buffer will incentivize boards to be more risk averse than necessary, which will again hurt performance of the fund. We also question whether this requirement would be more appropriately considered in a separate rulemaking, such as in the Commission's upcoming stress test rulemaking for RICs. The Commission could look to the CFTC's initial margin rules for a framework to apply in this situation; particularly given that the model used there has clear boundaries on the time period that should be assessed for examining periods of serious financial distress.

Board Requirements

While we support the adoption of a formal derivatives risk management program at the fund level, we have a number of suggestions with respect to the role of the appointed risk manager and the fund board in identifying potential risks stemming from derivatives exposures.

First, we believe that funds should have the flexibility to either appoint a designated risk manager or a committee of qualified individuals to assume this role. Having this option will provide the fund board with the flexibility to choose the appropriate personnel for this function. This approach also recognizes that an effective derivatives risk management program will need to draw from multiple disciplines,

[5] *See* footnote 40, Comments submitted by Simpson Thacher & Bartlett LLP, on behalf of certain clients that sponsor or advise registered investment companies and business development companies that focus on alternative investment strategies (Mar. 28, 2016).

including investment management and risk monitoring. This is particularly true given that funds, their investment strategies, and use of derivatives vary considerably throughout the industry.

Second, we believe that it is important to protect a derivatives risk manager (or a committee performing this function) from legal liability, especially given the inherent potential for incorrect but well-intentioned decisions to be made. Risk management necessarily is forward-looking and, often, disagreements can be made in good faith about actions that should be taken to reduce a portfolio's risk exposure. Clarifying that a derivatives risk manager acting in good faith would be shielded from liability for the normal performance of derivatives transactions is an important change that should be made to the Proposed Rule.

Third, we respectfully ask the Commission for clarification on whether a fund may terminate its derivatives risk management program if it falls below the 50 percent threshold (or ceases using "complex" derivatives). We also ask clarification as to whether early-stage funds need to implement a derivatives risk management program if they will quickly fall below the 50 percent threshold (e.g., situations in derivatives are used in the "ramp-up" of a fund, but the use of derivatives "rolls off" as a fund is capitalized).

Finally, with respect to the fund board's approval of the derivatives risk management program, we believe that clear lines should be drawn between oversight of the program and requiring boards to specifically approve the limits for a program.[6] Investment advisers are often best placed for making these decisions, while boards can focus on their traditional role of identifying and mitigating potential conflicts of interest. This would also more closely track the role of the board with respect to the Commission's proposed rule for liquidity risk management plans.

Business Development Companies

We also note that the Proposed Rule would apply the same portfolio limitations and asset segregation requirements to BDCs as it would to other funds. We believe such a proposal is inappropriate because it fails to recognize the meaningful operational differences between BDCs and other funds, and contradicts specific Congressional intent to provide greater leverage capacity to BDCs for the express purpose of increasing the

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[6] *See* Rule 38a-1 generally as an example of such board oversight.

flow of capital to small and mid-size U.S. businesses. Consequently, we believe the Proposed Rule should impose no new or different restriction on the borrowing or lending activities permitted of BDCs in the 1940 Act, and any exposure-based limitation applicable to BDCs under the Proposed Rule should reflect the greater leverage capacity extended to BDCs by Congress.

BDCs are a type of closed-end investment company created by Congress through enactment of the strongly bi-partisan Small Business Investment Incentive Act of 1980 and corresponding amendments to the 1940 Act.[7] Congress's stated objective in creating BDCs was to encourage the establishment of new capital vehicles that would invest in, and increase the flow of capital to, small and mid-sized companies in the United States.[8] As such, a BDC is generally required to invest at least 70 percent of its total assets in securities of private U.S. companies, unlisted public U.S. companies, or listed public U.S. companies that have an aggregate market value of less than $250 million.[9] Consistent with Congress's goal of providing support to small and mid-sized U.S. companies, the 1940 Act also requires BDCs to make available "significant managerial assistance" to portfolio companies.[10] Today, BDCs from across the industry have more than $83 billion in outstanding investments, the majority of which are in small and middle-market U.S. companies.[11]

BDCs have long been an important source of capital for small businesses, but they are becoming a critical source of capital for middle-market businesses as well.[12] Nearly 200,000 U.S. businesses comprise the middle-market, which translates into one-third of America's private sector gross domestic product.[13] Middle-market businesses employ more than 47 million people,[14] or one out of every three workers in the private sector.[15]

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[7] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980); see also S. Rep. No. 96-958 (1980); H.R. Rep. No. 96-1341 (1980). The Act was approved by the U.S. House by a vote of 395-1 and by unanimous consent in the U.S. Senate.
[8] *See* S. REP. NO. 96-958, at 1, 3 (1980).
[9] 17 CFR 270.2a-46.
[10] 15 U.S.C. 80a-2(a)(48)(B).
[11] FirstAdvantage Data, compiled from 2015 public earnings statements from BDCs filed through Q3 2015. According to FirstAdvantage, $76 billion of current BDC investments are in U.S. companies.
[12] The National Center for the Middle Market defines middle-market businesses as businesses with revenues between $10 million and $1 billion. *See*, 4Q 2015, Middle Market Indicator.
[13] 4Q 2015 Middle Market Indicator, National Center for the Middle Market.
[14] *Id.*
[15] *Id.*

As a result of the economic crisis, mid-size and small businesses have had a harder time accessing capital and the liquidity needed to grow and operate. While larger businesses can afford a higher cost of capital, others have been forced to find alternative means of financing. Since 2010, we have seen a large increase in financing to businesses, primarily mid-size firms, by BDCs. BDCs have become increasingly popular as the credit cycle and regulatory reaction to the financial crisis have made accessing debt financing more challenging.

The Chamber supports legislation that would increase the capital available to BDCs and enhance their ability to provide small and mid-size U.S. businesses with the funding needed to grow.[16] Under the Small Business Credit Availability Act, some BDCs could be treated as "well known, seasoned issuers" and thus be permitted to issue securities more quickly. Importantly, the Small Business Credit Availability Act would permit BDCs to use a modestly higher level of leverage, which, in turn, would empower them to provide even more capital to investment-starved middle-market companies. The Small Business Credit Availability Act would allow BDCs to play an even greater role in supporting the capital markets and more effectively fill the existing capital void that has hampered businesses and job growth since the Great Recession.

The Commission, however, would take a markedly different approach under the Proposed Rule than Congress is contemplating under the Small Business Credit Availability Act by drastically limiting the exposure limits of BDCs. Doing so ignores the fact that Congress intentionally permitted BDCs to issue senior securities and obtain additional leverage than other funds due to the clear differences in their fundamental purposes and structures. This difference warrants different treatment for BDCs under the Proposed Rule.

The CCMC and its members are concerned that the effect of the Proposed Rule as applied to BDCs may be to unfairly limit the amount of leverage a BDC might otherwise be permitted to use under the asset coverage requirements of the 1940 Act.[17] While this raises thorny issues as to the authority of an agency to limit by rule a statute regulating the same space, we believe such conflict is easily avoidable. The Commission should clarify the interplay between the Proposed Rule and the 1940 Act's asset coverage

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[16] *See* Statement of the U.S. Chamber of Commerce, On: Examining Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities, Tom Quaadman (Jun. 16, 2015), *available at* http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-tquaadman-20150616.pdf.
[17] 15 U.S.C. 80a-60(a)(1).

provisions so as to remove any doubt that the Proposed Rule would not (1) limit in any way a BDC's ability to utilize the full allotment of leverage permitted under the 1940 Act, or (2) prevent a BDC from also using a reasonable amount of derivatives in a responsible way.

One way the Commission could achieve this would be for the exposure-based portfolio limitation in the Proposed Rule to bear the same relationship between BDCs and RICs as exists between BDCs and RICs in the asset coverage provisions of the 1940 Act.[18] The Proposed Rule should honor and reflect this Congressionally-established relationship. Furthermore, this element of the Proposed Rule should be written in such a way as to automatically incorporate any subsequent legislative change to the 1940 Act's asset coverage requirements in case, for example, the Small Business Credit Availability Act or similar legislation were to be enacted.

Economic Analysis

Finally, we also note that the economic analysis performed by the Division of Economic Risk and Analysis suffers from several data limitations, meaning that the Commission was unable to fully evaluate the potential economic impact of the Proposed Rule. This is a serious flaw that warrants a significant reevaluation of the Proposed Rule, particularly after the Commission receives more information on how and in what quantities funds use derivatives.

When the rule was first proposed, Commissioner Piwowar dissented and noted that recent disclosure rules proposed by the Commission for RICs should be finalized prior to proposing new leverage limits, since such information would assist the Commission in establishing meaningful portfolio limitations based on economic analysis.[19] Commissioner Piwowar specifically noted that such information would help the Commission develop informed rulemaking on the regulation of derivatives. However, what has since been developed is a Proposed Rule that appears to arbitrarily limit the use of derivatives based on numerical thresholds that are inconsistent with

[18] Sections 18(a)(1)(A) and 18(f)(1) of the 1940 Act allow registered open-end and closed-end funds to borrow up to one-third the amount of their assets. Section 61(a)(1) of the 1940 Act allows BDCs to borrow up to one-half the amount of their assets. The resulting relationship is that BDCs can borrow 50% more than RICs. Accordingly, the Proposed Rule should allow BDCs a 50% higher exposure-based portfolio limit than RICs.

[19] *See* Commissioner Michael S. Piwowar, Dissenting Statement at Open Meeting on Use of Derivatives by Registered Investment Companies and Business Development Companies (Dec. 11, 2015), *available at* http://www.sec.gov/news/statement/piwowar-dissentingstatement-use-of-derivatives-funds.html.

comparable regulation at the CFTC, and severely limit what may constitute qualifying coverage assets.

We strongly believe that the Commission should collect more data and reassess whether the Proposed Rule is appropriate and properly balances investor protection with maintaining fair, orderly, and efficient markets, and facilitating capital formation. In particular, the Commission should consider the data prepared by the Investment Company Institute on how portfolio limitations will impact their membership in finalizing the Proposed Rule.[20]

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In sum, the CCMC believes that the Proposed Rule should be significantly modified before adoption, given the fact that the current portfolio limitations and asset segregation requirements appear to target particular types of investment companies. Forcing these funds to deregister will impede economic growth and the strength of our capital markets on the basis of an improper and not fully developed economic analysis. However, given that the Commission has the requisite expertise to develop these rules versus other regulators, the Commission should be given the opportunity to revisit the Proposed Rule after accepting and analyzing additional data on the use of derivatives by funds.

Thank you for your consideration of these views and we stand ready to discuss these issues with you further.

Sincerely,

Tom Quaadman

Cc: The Honorable Mary Jo White
The Honorable Michael Piwowar
The Honorable Kara Stein

[20] *See* supra at 2.