ARES

March 28, 2016

VIA ELECTRONIC DELIVERY

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

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

Dear Mr. Fields:

Ares Capital Corporation ("we", "us", "our" or "ARCC") is pleased to provide comments on proposed Rule 18f-4 (the "Proposed Rule") under the Investment Company Act of 1940 (the "1940 Act"), which was published for comment by the Securities and Exchange Commission (the "SEC" or "Commission") in Release No. IC-31933 (the "Proposing Release").[1] If adopted, the Proposed Rule would regulate the use of certain "senior securities" transactions[2] by management investment companies registered under the 1940 Act ("RICs") and business development companies ("BDCs," and collectively with RICs, "funds").

ARCC is a specialty finance company that has elected to be regulated under the 1940 Act as a BDC.[3] ARCC provides one-stop solutions to meet the distinct and underserved financing needs of private middle-market companies across diverse industries. As of December 31, 2015, ARCC had approximately $9.5 billion of total assets.

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1 *Use of Derivatives by Registered Investment Companies and Business Development Companies*, Release No. IC-31933 (Dec. 11, 2015), 80 Fed. Reg. 80884 (Dec. 28, 2015), *available at* https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf.

2 "Senior securities transaction" is defined in the Proposed Rule as "any derivatives transaction, financial commitment transaction, or any transaction involving a senior security entered into by the fund pursuant to section 18 [of the 1940] Act without regard to the exemption provided by this section." *See* Proposed Rule 18f-4(c)(10).

3 ARCC is externally managed by Ares Capital Management LLC ("ACM"). ACM is registered with the SEC as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act"). ACM's parent, Ares Management, L.P. (collectively with its subsidiaries, "Ares"), is a publicly traded, global alternative asset manager. Ares operates three investment groups that invest in the credit, private equity and real estate markets. As of December 31, 2015, Ares and its affiliates had approximately $94 billion of assets under management. Ares Capital Management II LLC ("ACM II"), another Ares affiliate that is registered as an investment adviser under the Advisers Act is the investment adviser to Ares Dynamic Credit Allocation Fund, Inc., a closed-end RIC incorporated under the laws of the State of Maryland and listed on the New York Stock Exchange. ACM II also sub-advises a number of open-end RICs.

Congress created BDCs pursuant to the Small Business Investment Incentive Act of 1980 (the "SBIIA") as a means of making capital more readily available to small and medium-sized, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing.[4] Currently, BDCs have over $70 *billion in* outstanding loans to middle market American businesses.[5] The imposition of additional restrictions on the investment activities of BDCs, such as those included in the Proposed Rule relating to conditional obligations to make a loan to portfolio companies, are unnecessary in light of the existing regulatory regime and would impair the flexibility of BDCs to fulfill their Congressional mandate.[6] Folding BDCs within the scope of the Proposed Rule would violate Congressional intent by defeating the entire purpose for which BDCs were created and place greater restrictions on BDCs' ability to operate than Congress intended. We therefore respectfully submit that the Proposed Rule should not apply to BDCs. We do not believe that the SEC and its staff fully accounted for the purpose of BDCs and the separate statutory provisions that were specifically created for BDCs when the SEC determined to apply the Proposed Rule to BDCs and RICs in the same manner.

The SEC's stated intent in proposing the Proposed Rule is to "address the investor protection purposes and concerns underlying [S]ection 18 of the [1940] Act and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives in light of the increased participation by funds in today's large and complex derivatives markets over the past two decades and the increased use of derivatives by certain funds."[7] In addition to addressing these stated purposes, however, the Proposed Rule would also regulate "financial commitment transactions," defined in the Proposed Rule to include conditional obligations to make a loan, such as delayed draw term loans, revolving loans and similar conditional loans (referred to in this letter as "unfunded loan commitments"). This aspect of the Proposed Rule creates new rules for unfunded loan commitments, which, as ordinary course commercial instruments, bear no resemblance, and present no similar risks, to the "derivatives transactions" and other "financial commitment transactions" addressed by the Proposed Rule (*i.e.*, they are commercial loan arrangements, typically subject to multiple funding conditions, that are offered by BDCs to support the growth needs of small and medium-sized American businesses). In fact, unfunded loan commitments often provide vital "growth-on-growth" capital to these businesses consistent with the Congressional mandate for BDCs, at a time when banks are retrenching from the space (*i.e.*, they are offered to these businesses in connection with an initial loan in order to

4 *See generally* H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980).

5 *See* Small Business Investor Alliance: BDC Modernization Agenda, Legislative Recommendations for Members of the 114th Congress (2015).

6 We note that another regulator has issued guidance acknowledging the unique function of BDCs. *See* Commodity Futures Trading Commission (the "CFTC") No-Action Letter 12-40 (Dec. 4, 2012) (granting relief to BDCs, subject to certain conditions, from the commodity pool operator registration requirement of CFTC Regulation 4.5).

7 Proposing Release at 1.

provide them with capital to support future growth (organically through capital expenditures or by acquisition)).

Under the Proposed Rule, a BDC that engages in unfunded loan commitments would be required to maintain, with respect to each such unfunded loan commitment, "qualifying coverage assets"[8] with a value equal to at least the amount of cash or other assets that the BDC is conditionally or unconditionally obligated to pay or deliver under the financial commitment transaction, or, where the BDC is conditionally or unconditionally obligated to deliver a particular asset, the value of the asset.[9] This would effectively require BDCs (as well as other funds engaging in similar commercial financing transactions) to maintain and set aside cash and cash equivalents (as well as other assets convertible into cash) to "cover" these transactions, which are often long-term commitments by their nature, instead of using those assets to finance American businesses that create or maintain American jobs. We respectfully submit that denying such businesses an important source of growth capital, as we believe would be a direct effect of the Proposed Rule, would have adverse consequences for a vital component of the American economy.

The Proposing Release refers to Investment Company Act Release 10666, in which the SEC addressed reverse repurchase agreements, firm commitment agreements, and standby commitment agreements in the context of Section 18 of the 1940 Act.[10] Release 10666 was published in 1979. Sections 54 – 65 of the 1940 Act, which establish and regulate BDCs, were added to the 1940 Act through the SBIIA in 1980. Unfunded loan commitments were in existence by that time as a type of financing of portfolio companies. If Congress had intended that BDCs treat unfunded loan commitments as similar to senior securities for purposes of Release 10666, it could have so provided in Section 61 of the 1940 Act or elsewhere in the SBIIA. That Congress did not do so is consistent with the overall regulatory scheme applicable to BDCs under the SBIIA, which treats BDCs differently from, and offers them more flexibility than, traditional RICs. Moreover, unlike the transactions discussed in Release 10666, unfunded loan commitments are not bets on interest rate movements or otherwise speculative investments. Unfunded loan commitments are instead commercial contracts between two parties subject to conditions to performance.

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8 The Proposed Rule defines "qualifying coverage assets" for financial commitment transactions to generally include cash, cash equivalents and "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." *See* Proposed Rule 18f-4(c)(8). BDCs do not typically pledge assets with respect to the making of unfunded loan commitments.

9 *See* Proposed Rule 18f-4(b)(1), 18f-4(c)(5) and 18f-4(c)(8).

10 *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release 10666"). Release 10666 did not apply Section 18 to unfunded loan commitments.

Given the Congressional mandate for BDCs to serve as important sources of financing to small and medium-sized American companies, we are also concerned with the Proposed Rule's inclusion of unfunded loan commitments as "senior security" transactions. Among other things:

- If the Proposed Rule is adopted, the definition of "financial commitment transaction" should not include a conditional obligation to make a loan such as an unfunded loan commitment. These commercial contracts are dependent on the borrower meeting a number of conditions prior to the funding of the loan, including advance notice, and do not give rise to the risks identified in Release 10666 or otherwise unduly increase the speculative character of the fund's outstanding securities. Further, these commercial contracts generally do not require a BDC to pledge assets to secure its *contingent* obligations under unfunded commitments or, as discussed in more detail below, require a BDC to settle via a cash payment without creation of an associated asset on the BDC's balance sheet.

- If the Proposed Rule as adopted includes within the definition of "financial commitment transaction" conditional obligations to make a loan to a company, such as through unfunded loan commitments, the definition of "qualifying coverage assets" should be expanded to include available capacity under revolving lines of credit.

In addition, under the Proposed Rule, a BDC that engages in even a single derivatives transaction (for example, to manage interest rate or currency risk as a responsible steward of capital for its shareholders) would also be required to comply with one of two alternative portfolio limitations on the aggregate amount of leverage the fund may obtain through derivatives transactions, financial commitment transactions, and other "senior securities" transactions contemplated by the 1940 Act.[11] These portfolio limitations do not account for the modified asset coverage requirements that Congress in 1980 made specifically applicable to BDCs' use of leverage pursuant to Section 61 of the 1940 Act. We also believe that the portfolio exposure limitations under the Proposed Rule should recognize the lower volatility of the interest rate and credit markets compared to other markets.

As discussed below, the Proposed Rule should clarify the exemptions from Section 18 of the 1940 Act that are being provided.

Finally, we respectfully submit that the changes contemplated by the Proposed Rule would be more appropriately addressed legislatively than by rulemaking.

Our comments on the Proposed Rule are set out more fully below.

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[11] *See* Proposed Rule 18f-4(a)(1) and 18f-4(c)(3).

I. Specific Comments With Respect to the Proposed Rule

A. Unfunded Loan Commitments

i. The Definition of Financial Commitment Transactions Should Not Include a Conditional Obligation to Make a Loan Such as an Unfunded Loan Commitment

The Proposed Rule includes as a financial commitment transaction "an agreement under which a fund has obligated itself, *conditionally* or unconditionally, to make a loan to a company."[12] The Proposing Release states that funds often refer to these agreements as "unfunded commitments."[13] Examples of unfunded loan commitments typically entered into by funds, particularly BDCs, include: (1) "revolving" loans (*i.e.*, loans that can be incurred, paid down, and re-drawn by a borrower, often for working capital purposes); and (2) "delayed draw" term loans whereby the fund agrees to fund additional amounts to a borrower, funded only upon the occurrence of a specific event (*e.g.*, to finance an acquisition by the borrower). For the reasons discussed below, conditional obligations to make a loan such as unfunded loan commitments should not be included in the definition of financial commitment transactions.

1. Unfunded Loan Commitments are a Standard and Ordinary Course Component of Active Lending

Unfunded loan commitments, such as revolving loans and delayed draw term loans, are standard contracts into which BDCs enter regularly and are of particular importance to BDCs' portfolio companies. In fact, unfunded loan commitments are not a new concept. These commercial contracts were entered into by borrowers and lenders long before BDCs were added to the 1940 Act in 1980. Including unfunded loan commitments in the definition of financial commitment transactions (thereby requiring BDCs and other funds to maintain "qualifying coverage assets" with respect to conditional amounts that may be drawn and potentially requiring a new asset coverage test to include these) would impede a BDC's ability to provide such loans, thus jeopardizing the ability of BDCs to fulfill their specific Congressional mandate to furnish capital primarily to small and medium-sized American companies and hindering the growth and job-creation prospects of the companies BDCs were designed to assist. In fact, companies that seek financing from BDCs view these unfunded loan commitments as "growth-on-growth" capital, meaning the company receives financing for an initial loan to grow its business while also entering into an unfunded loan commitment, which allows the company to obtain additional financing in the future (subject to conditions) without having to spend time and resources negotiating a new loan with its lenders. At a time when banks simply will not provide unfunded loan commitments to these businesses, curtailing the ability of BDCs to provide these loans would adversely harm small and medium-size American businesses. Other funds that invest in

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[12] Proposed Rule 18f-4(c)(4). (emphasis added).

[13] Proposing Release at 59.

loans, particularly closed-end RICs, may offer borrowers unfunded loan commitments for similar purposes.

2. Unfunded Loan Commitments Do Not Share the Attributes Associated with "Senior Securities"

The Proposed Rule's definition of a financial commitment transaction "is designed to describe the trading practices addressed in Release 10666", which the SEC states in the Proposing Release "*involve* the issuance of a senior security."[14] We respectfully submit that Release 10666 stated that "[s]uch practices *may* involve the issuance by the investment company of a senior security subject to the prohibitions and asset coverage requirements of Section 18 of the [1940 Act]."[15] Thus, the SEC's view of the transactions identified in Release 10666 seems to have changed. In any event, unlike the reverse repurchase agreements, firm commitments and standby commitments discussed in Release 10666, unfunded loan commitments are not issued in connection with any securities trading practices, nor do they affect a fund's capital structure in a manner analogous to the transactions described in Release 10666. For instance, unfunded loan commitments are not entered into to allow a fund to participate in gains and losses on amounts that exceed a fund's investment, nor do they subject the fund to a risk of loss in excess of the commitment fees the fund would receive as consideration for making such commitment. A fund's unfunded loan commitments also do not present a risk of speculative loss – a risk of a realized loss only exists if the commitment is actually funded *and* the BDC suffers a loss on the loan issued under the commitment. The Proposing Release discusses the SEC's concern that financial commitment transactions (i) require the party making the commitment to fund the commitment at the discretion of the counterparty, and (ii) have the potential to result (in the event of default by the party making the commitment) in losses to the party making the commitment.[16] However, a fund's unfunded loan commitments, which require a number of conditions to be met prior to the funding of the loan, including notice periods, do not give rise to these risks or otherwise unduly increase the speculative character of the fund's outstanding securities.[17] The conditions are typically set stringently enough for drawdown that the commitment itself should create no increased risk over that contained in another loan structure. Once the loan is funded, a fund's risk is no different than for any other ordinary course loan.

In addition, unlike the transactions identified in Release 10666, unfunded loan commitments also do not reflect a bet on interest rate movements. Yields for unfunded loan commitments are determined on the date the commitment is made and reflect a yield that is determined as a spread over a prevailing market interest rate, typically a spread over LIBOR,

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14 Proposing Release at 58. (emphasis added).

15 Release 10666. (emphasis added).

16 *See* Proposing Release at 59.

17 *See* Proposing Release at 14 ("Congress' concerns underlying the limitations in section 18 were focused on . . . excessive borrowing and the issuance of excessive amounts of senior securities by funds which increased unduly the speculative character of their junior securities . . . .").

which floats. As the SEC stated in Release 10666, "[c]ommitments to purchase securities whose yields are determined on the date of delivery with reference to prevailing market interest rates are not intended to be included in this general statement of policy. Such commitments neither create nor shift the risk associated with interest rate changes in the marketplace, and in economic reality have no discernible potential for leverage."[18] We respectfully submit that contingent obligations to make a loan such as unfunded loan commitments fit this description and were never intended to be within the scope of Release 10666.

The Proposing Release also discusses unfunded capital commitments to a private fund that can be drawn at the discretion of the private fund's general partner, noting that "the [committing] fund would be exposed to risks as a result of these transactions in that the fund may be required to liquidate other assets of the fund to obtain the cash needed by the fund to satisfy its obligations" and if "the fund fails to fulfill its commitments to invest in a private fund when called to do so, the fund could be subject to the remedies specified in the limited partnership agreement (or similar document) relating to that private fund, which can include, for example, a forfeiture of some or all of the fund's investment in the private fund."[19] Unfunded loan commitments are materially different from these types of transactions. As an initial matter, a fund's unfunded loan commitments are subject to the counterparty making certain representations and warranties to the fund and include financial or non-financial covenants and conditions that must be achieved before the commitment can be drawn by the borrower. Delayed draw term loan commitments also include milestones or other conditions that must be achieved or satisfied before the commitment can be drawn by the borrower (*e.g.*, a pre-negotiated specific use of proceeds, such as the consummation of an acquisition by such counterparty). In addition, if a fund were to breach a commitment to make a loan, the typical damages would be sought through a claim for breach of contract. When a lender breaches a commitment to make a loan, "the basic measure of damages is not the amount agreed to be loaned or advanced, but rather the expense of getting another loan, consisting principally of the difference between the interest that the borrower contracted to pay and what he or she was compelled to pay to procure a replacement loan, although the borrower may not recover more than the difference between the interest contracted for and that represented by the highest rate of interest allowed by law or the generally prevailing rate, the theory being that money is always procurable in the market at the lawful rate of interest."[20] This is clearly different from the types of risks expressed by the SEC in Release 10666.

Thus, we respectfully submit that unfunded loan commitments should not be included within the Proposed Rule's definition of financial commitment transactions.[21]

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[18] *See* Release 10666 at fn. 12.

[19] Proposing Release at 59.

[20] 25 Richard A. Lord, Williston on Contracts § 66:100 (4th ed.).

[21] If, as discussed in this letter, the SEC removes unfunded loan commitments from the definition of financial commitment transactions in the Proposed Rule, we believe that it would be useful for the SEC to state explicitly that unfunded loan commitments would not be considered a "senior security" when calculating a fund's asset

ii. The Definition of "Qualifying Coverage Assets" Should be Expanded to Include Available Capacity Under Revolving Lines of Credit.

While it is our view, for the reasons discussed above, that unfunded loan commitments (which can only be drawn down by the borrower if certain conditions are met) should not be included in the Proposed Rule's definition of financial commitment transactions, if the Proposed Rule, as adopted, does include unfunded loan commitments within the definition of financial commitment transactions, [22] we believe that a fund should be able to include its available revolving credit facilities as qualifying coverage assets.

Under the Proposed Rule, "qualifying coverage assets" include, with respect to financial commitment transactions, "assets" that are convertible to cash or that will generate cash equal in amount to the "financial commitment obligation."[23] A fund's "financial commitment obligation" with respect to any financial commitment transaction is currently proposed to be defined as the amount of cash or other assets that the fund is conditionally or unconditionally obligated to pay or deliver under the financial commitment transaction, or the value of the asset to be delivered.[24]

The SEC notes in the Proposing Release that "the timing of the fund's payment obligations [under financial commitment transactions] may be specified under the terms of the financial commitment or the fund may otherwise have a reasonable expectation regarding the timing of the fund's payment obligations with respect to its financial commitment transactions."[25] The SEC states that with respect to financial commitment transactions a fund could count as a qualifying coverage asset under the Proposed Rule a fixed income security that (i) would mature in time for the fund to use the principal payment to complete a firm commitment agreement, or (ii) would generate a sufficient amount in interest payments such that that the fund could use such payments to satisfy a firm commitment agreement.[26] While these types of assets are important to ensuring liquidity to meet a fund's obligations, we believe that a key source of liquidity for BDCs and closed-end RICs has been overlooked, which is liquidity that is available through revolving credit facilities.

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coverage under Section 18(h) of the 1940 Act for purposes of determining the fund's compliance with Section 18 of the 1940 Act.

22 If unfunded loan commitments continue to be included in the definition of financial commitment transactions under the Proposed Rule, a BDC would be required to determine qualifying coverage assets at least once each business day, and maintain a written record of such daily determinations. *See* Proposed Rule 18f-4(b)(1) and (b)(3)(ii). Introducing a daily determination of asset coverage to BDCs' operations would be extremely burdensome, and would be unlikely to generate an offsetting benefit given the illiquid nature of BDCs' assets and the relatively static nature of funding commitments under unfunded loan commitments. Accordingly, we believe that a less frequent determination would be appropriate.

23 *See* Proposed Rule 18f-4(c)(8).

24 *See* Proposed Rule 18f-4(c)(5).

25 Proposing Release at 239.

26 *See* Proposing Release at 239.

As a matter of managing liquidity to fund commitments, many BDCs have in place revolving credit facilities so that they have sufficient liquidity to fund their investment activities without having to carry excess, low yielding cash on their balance sheets. It is common practice for BDCs to balance unfunded loan commitments with capacity under these facilities and manage accordingly. If a fund has a credit facility that it can draw down within a specified time period, the available amount should be included as a "qualifying coverage asset" with respect to unfunded loan commitments. The existence of a credit facility mitigates the risk that a fund would be unable to meet its unfunded loan commitments when drawn. Unlike open-end RICs, BDCs and closed-end RICs do not have to manage for redemptions, which allows these funds to more accurately predict their liquidity needs with respect to unfunded loan commitments and other fund obligations. In addition, unlike the more liquid transactions of an open-end fund, the commitments made by BDCs generally have longer visibility horizons and thus allow for more time for the fund to be ready to fund such commitments.

If this change is not made, the Proposed Rule's definition of "qualifying coverage assets" would require BDCs to maintain excess cash, cash equivalents and other assets convertible into cash in their portfolios. A potential consequence would be a reduction in a BDC's earnings, as the yield on cash and cash equivalents is nominal relative to a BDC's cost of debt and equity capital. The resulting cash drag from this requirement could result in a reduction in distributions to a BDC's own investors and would reduce the assets BDCs would have available to fulfill their Congressional mandate. As commercial banks and other traditional financing sources continue to retrench from the business of providing loans to small and medium-sized American businesses, BDCs play a crucial role in helping these companies meet their capital needs. In this respect, the Proposed Rule would further limit the financing available to the American businesses BDCs were designed to aid, thus impeding such businesses from continuing to grow and provide employment opportunities to American workers.

B. The Exposure Limitations Introduced by the Proposed Rule Do Not Recognize the Uniqueness of BDCs or the Credit Markets in General

i. The Exposure Limitations Should Account for the Unique Asset Coverage Requirements Under Section 61 Applicable to BDCs

The Proposed Rule would subject a fund that engages in a single derivatives transaction to an exposure-based portfolio limit of 150 percent or 300 percent[27] (relative to the fund's net assets) on its aggregate notional "exposure" to senior securities transactions (which would include derivatives transactions, financial commitment transactions, and any debt or preferred stock pursuant to Section 18 of the 1940 Act).[28] As proposed, the exposure limitations would

[27] The 300 percent limitation also includes a risk-based test. *See* Proposed Rule 18f-4(a)(1)(ii).

[28] Under the Proposed Rule, the "exposure" numerator includes the sum of: (1) aggregate notional amounts of the fund's derivatives transactions; (2) aggregate "financial commitment obligations" of the fund (including, in the case of unfunded loan commitments, conditional commitments to extend a loan in the future based on the satisfaction of certain conditions); and (3) the aggregate indebtedness or involuntary liquidation preference, as

apply equally to RICs and BDCs. The SEC inquires in the Proposing Release whether the Proposed Rule should "provide BDCs greater exposure limits under the rule in recognition of the greater latitude that BDCs have to issue senior securities provided by section 61."[29] We strongly recommend that BDCs have higher exposure limits than RICs if the final rule is applied to BDCs, so that they have the same capacity to enter into derivatives transactions and financial commitment transactions as RICs after taking into account BDCs' increased leverage authority pursuant to Section 61.

Section 61 of the 1940 Act clearly shows the Congressional intent to subject BDCs to more liberal leverage limitations than RICs. Section 61(a)(1) of the 1940 Act prohibits the issuance by a BDC of any "senior security" representing indebtedness unless the BDC will have 200 percent asset coverage with respect to such "senior security" representing indebtedness immediately after such issuance. In contrast, Sections 18(a)(1) and (f) of the 1940 Act impose a more restrictive 300 percent asset coverage requirement on RICs with respect to the issuance of any "senior security" representing indebtedness (for closed-end RICs) or bank borrowings (for open-end RICs). Section 61(a)(2) of the 1940 Act permits BDCs, unlike closed-end RICs, to issue more than one class of "senior security" representing indebtedness. The Proposed Rule disregards Congressional intent to provide for increased leverage flexibility for BDCs. If adopted as proposed, the Proposed Rule would subject BDCs that use even a single derivatives contract to exposure limitations that are designed for RICs subject to a more restrictive asset coverage test for indebtedness, and would thereby effectively limit the BDCs' ability to use derivatives transactions and financial commitment transactions in addition to senior securities authorized by Congress in a manner that is disproportionate to the limit applicable to RICs. If the Proposed Rule, as adopted, subjects BDCs to exposure-based portfolio limitations, such limitations should take into account the difference in the statutorily-imposed asset coverage limitations applicable to RICs and BDCs in order to ensure consistency with the Congressional intent of the SBIIA and reflect the lower asset coverage ratio applicable to BDCs.

ii. The Exposure Limitations under the Proposed Rule Should Recognize the Lower Volatility of the Credit Markets

We invest in the credit markets, as do RICs advised by ACM II.[30] Derivatives may be used to hedge interest rate risk or, in the case of the RICs, to gain exposure to investments in the credit markets. As proposed, the exposure calculation does not account for the differentiated risk of the underlying reference asset of a derivatives transaction, particularly interest rate and credit-based instruments. Given the size of the notional amounts potentially required to hedge interest rate risk for a fund, the Proposed Rule's "exposure" calculation for derivatives transactions, which would count the notional amount of an interest rate derivative towards a fund's exposure, could impede our ability to manage interest rate risk for our funds and their investors. We urge

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applicable, with respect to any senior securities transaction entered into by the fund pursuant to Sections 18 or 61 of the 1940 Act. *See* Proposed Rule 18f-4(c)(8).

29 Proposing Release at 109.

30 Although the RICs predominantly invest in securities, they maintain the flexibility to gain exposure through investments in derivatives.

the SEC to establish an objective risk adjustment framework in any final rule that would recognize the less volatile nature of credit instruments such as interest rate derivatives and bonds in comparison to other asset classes such as equities. Such a framework would count only a portion of the notional amount of a derivatives transaction where the underlying asset is less volatile (*e.g.*, short duration bonds) towards the fund's "exposure" as defined in the Proposed Rule.

C. The Proposed Rule Should Clarify the Exemptions being Provided from Section 18 of the 1940 Act

The Proposed Rule provides an exemption from the requirements of Sections 18 and 61 of the 1940 Act for derivatives transactions and financial commitment transactions. In the Proposing Release, the SEC asks how a fund should treat derivatives transactions or financial commitment transactions when a fund is calculating asset coverage under Section 18(h) for senior securities transactions permitted by Section 18 or Section 61.[31] We do not believe the Proposed Rule, if adopted, should change the manner in which funds calculate asset coverage under Section 18(h) of the 1940 Act, which should continue to be calculated in accordance with generally accepted accounting principles (GAAP). Moreover, funds that file on Form N-2 should not be required to include derivatives transactions and financial commitment transactions in the senior securities table.

In addition, as currently structured, the Proposed Rule, would seem (without explanation, and perhaps inadvertently) to disfavor BDCs and closed-end RICs that issue preferred stock. The list of provisions to which the Proposed Rule provides an exemption does not include Section 18(a)(2) (relating to senior securities that are stock). If the final version of the Proposed Rule does not provide an exemption from the requirements of Section 18(a)(2) and if the SEC were to interpret derivatives transactions and financial commitment transactions to be senior securities representing indebtedness of a fund, then BDCs and closed-end RICs that issue preferred stock may not be able to enter into derivatives and financial commitment transactions without including such transactions as "senior securities representing indebtedness of such issuer" in the denominator of the 200 percent asset coverage test for senior securities that are stock.[32] As a result, we recommend including Section 18(a)(2) in the list of sections to which the exemption applies.

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31 Proposing Release at 63.

32 Section 18(h) states, in relevant part: "'Asset coverage' of a class of senior security of an issuer which is a stock means the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the *aggregate amount of senior securities representing indebtedness of such issuer* plus the aggregate of the involuntary liquidation preference of such class of senior security which is a stock." (emphasis added.)

II. Congressional Intent

A. The Proposed Rule is Contrary to Congressional Intent Behind BDCs

Congress created BDCs pursuant to the SBIIA as a permanent capital vehicle designed to make 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.[33] To accomplish this purpose, the SBIIA imposed restrictions on the activities of BDCs, including generally requiring a BDC to invest at least 70% or more of its total assets in certain types of companies.[34] As discussed in more detail above, Congress also amended the 1940 Act through the SBIIA to liberalize the leverage and senior security provisions in the 1940 Act as applied to BDCs in order to facilitate the operation of BDCs.[35] These liberalized provisions facilitate a BDC's ability to maximize the amount of capital available for deployment to small and medium-sized American businesses.

The imposition of additional restrictions on the activities of BDCs, such as those included in the Proposed Rule relating to unfunded loan commitments, are unnecessary in light of the existing regulatory regime and would impair the flexibility of BDCs to achieve their Congressional mandate (*i.e.*, to provide capital to small and medium-sized American businesses). Any such impediment to the ability of BDCs to provide financial assistance to the American businesses they were established to assist will result in adverse consequences for those businesses, including restricting their potential for growth and ultimately limiting their capacity to provide jobs to American workers.

Thus, folding BDCs within the scope of the Proposed Rule would violate Congressional intent by defeating the entire purpose for which BDCs were created and place greater restrictions on BDC's ability to operate than Congress intended.

B. Congress Has Already Defined the Term "Senior Security"

As stated above, the Proposed Rule would define "senior securities transaction" to include any "financial commitment transaction."[36] In turn, the term "financial commitment transaction" would be defined to include unfunded loan commitments such as revolvers and

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33 *See generally* H.R. Rep. No. 1341, 96th Cong., 2d Sess. 21 (1980).

34 *See* Section 55(a) of the 1940 Act.

35 *See* Section 61 of the 1940 Act. As discussed above, the SEC issued Release 10666 in 1979. Congress therefore would have been aware of Release 10666 when drafting the provisions of the 1940 Act that apply to BDCs. We are not aware of any SEC testimony relating to the SBIIA that sought to extend the principles of Release 10666 to ordinary course investment activities of BDCs.

36 Proposed Rule 18f-4(c)(10).

delayed draw term loans.[37] We respectfully submit that Congress has already defined what constitutes a "senior security" and only Congress has the authority change this definition.

First, Congress has already directly addressed the question of what constitutes a "senior security" by defining the term in Section 18(g) of the 1940 Act itself.[38] The definition does not include unfunded loan commitments, and nothing in the text of Section 18(g) expressly gives the SEC authority to expand or modify that definition.

Second, while the Proposing Release identifies various provisions of the 1940 Act as vesting the SEC with the statutory authority for promulgating the Proposed Rule,[39] we respectfully submit that none of those provisions provides the SEC with authority to expand the Congressional definition of "senior security."[40] The SEC also appears to have concluded that it has the authority to promulgate the Proposed Rule because a "core purpose" of the 1940 Act is the "protection of investors" and the Proposed Rule, if adopted, would further that purpose.[41] There can be no doubt that the protection of investors was one of the purposes Congress meant to serve in passing the 1940 Act and that the SEC is required to consider those interests (among other things) in promulgating any rules, regulations or orders.[42] But we respectfully submit that it is a different matter altogether to conclude that the SEC has the authority to promulgate rules and regulations so long as they advance that purpose. To the contrary, where Congress meant to give the SEC authority to prescribe rules or regulations "as necessary or appropriate for the protection of investors," it did so expressly.[43] For BDCs (and open-end and closed-end

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37 *See* Proposed Rule 18f-4(c)(4).

38 Section 18(g) provides: "'[s]enior security' means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividend…."

39 *See* Proposing Release at 407.

40 Section 6(c), for example, concerns the SEC's authority to create certain exemptions from the strictures of the 1940 Act. But the Proposed Rule does not seek to *exempt* unfunded loan commitments from the definition of "senior security." Rather, it seeks to *expand* the definition to include transactions that were not previously within its scope. Section 12(a), also cited in the Proposing Release, gives the SEC authority to prescribe rules related to: (1) purchasing securities on margin; (2) participating on a joint or a joint and several basis in any trading account in securities; and (3) effecting a short sale of any security. None of these acts has anything to do with defining "senior security" for purposes of Sections 18 or 61 or regulating unfunded loan commitments. Section 31(a), also cited in the Proposing Release, does not provide the requisite authority to expand the definition of "senior security" either, as it relates to the maintenance of records. Section 38(a) provides that the SEC has the authority "to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission *elsewhere in this title*." (emphasis added). Accordingly, this section provides that the SEC may make rules and regulations in exercise of the authority granted to it in *other provisions* of the 1940 Act; it does not provide for an independent grant of authority itself.

41 Proposing Release at 14.

42 *See* Sections 1(b) and 2(c) of the 1940 Act.

43 *See, e.g.*, Section 2(a)(46)(C)(iv) of the 1940 Act (granting authority to establish criteria under which an issuer is an "eligible portfolio company"); Section 3(c)(1)(B) of the 1940 Act (granting authority to prescribe rules defining "beneficial ownership" within the definition of "investment company"); Section 3(c)(7)(A) of the 1940

management RICs), it did not grant such authority at all in Section 61 or 18, as applicable. Furthermore, the Proposed Rule may result in harm to the shareholders of BDCs (*i.e.*, as discussed above, the Proposed Rule's changes to asset segregation requirements may reduce the amount of such BDC's distributions).

Third, as more fully explained above, there are many other reasons why unfunded loan commitments do not meet the plain definition of a senior security. As a threshold matter, it is not insignificant that the SEC itself stopped short of concluding in Release 10666 that the types of transactions now being characterized as "financial commitment transactions" (including unfunded loan commitments) constitute "senior securities" within the meaning of the 1940 Act.[44] To now declare 36 years later that unfunded loan commitments (as well as other financial commitment transactions) *must* involve the issuance of senior securities within the meaning of Section 18 would break with the SEC's prior determination and result in BDCs and RICs being forced to change their business models overnight – to the detriment of both shareholders and American jobs.

III. The SEC Failed to Conduct a Proper Cost/Benefit Analysis

In promulgating rules, Section 2(c) of the 1940 Act requires the SEC to determine "whether the action will promote efficiency, competition, and capital formation." As the Proposing Release itself makes clear, we respectfully submit that the SEC has not adequately made the required assessment.

For example, in the Proposing Release, the SEC acknowledges that it failed to assess whether the Proposed Rule would promote efficiency, competition and capital formation, stating: "In many cases," the SEC is "unable to quantify the economic effects because [the SEC] lack[s] the information necessary to provide a reasonable estimate."[45] The Proposing Release also contains many equivocal statements, including, by way of example only, that "the proposed rule may lead to an increase or decrease in the use of particular derivatives or an increase or decrease in derivatives use by particular funds."[46] We respectfully submit that statements like this demonstrate that the SEC has failed to conduct the required analysis, and should not adopt the Proposed Rule until it has enough information to fully and fairly judge its effects.[47]

Act (granting authority to prescribe rules defining "qualified purchaser" within the definition of "investment company"); Section 19(a) of the 1940 Act (granting authority to prescribe the form of a written statement to disclose dividends); Section 26(b) of the 1940 Act (granting authority to prescribe conditions under which a bank or affiliated person may serve as a trustee or custodian).

44 *See* Release 10666 (concluding that certain practices relating to reverse repurchase agreements, firm commitment agreements, and standby commitment agreements "*may* involve the issuance by the investment company of a senior security subject to the prohibitions and asset coverage requirements of Section 18") (emphasis added).

45 Proposing Release at 274.

46 Proposing Release at 280.

47 *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) (noting that SEC

This issue is compounded for BDCs by the fact that no mention of BDCs is even made in the cost/benefit analysis that the SEC did conduct. In particular, with respect to financial commitment transactions, the SEC states that its "estimate of affected funds does not include . . . BDCs."[48] The Proposing Release also states, in conclusory fashion, that "88 BDCs would also comply with the asset segregation requirements in proposed rule 18f-4 (applicable to financial commitment transactions)."[49] We respectfully submit that this passing reference is no substitute for the economic analysis the SEC is required to make under Section 2(c) to properly consider the impact that the Proposed Rule would have on those affected, including BDCs.

In no sense should this be considered a mere technical failure. As explained elsewhere in this letter, the Proposed Rule will impose significant costs on BDCs and their investors, as well as portfolio companies. The Proposed Rule could therefore not only harm the BDCs themselves, but the broader economy by reducing distributions to "Main Street" BDC investors and depriving small and medium-sized American businesses of a sorely needed source of funding.

In our respectful submission, the SEC must fulfill its mandate to consider and assess the economic effects of the Proposed Rule *before* it is promulgated, not after, particularly where (as here) its negative impact on BDCs, their shareholders and the economy could be severe.

IV. Conclusion

We appreciate the opportunity to provide our comments on the Proposed Rule, particularly from the perspective of BDCs and the portfolio companies in which they invest.

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should wait until other recently proposed or adopted rules are implemented, which "will provide [the SEC] with data that could be used to better understand how we should regulate this market").

48 Proposing Release at 325.

49 *Id.*

We hope the SEC and its staff find our comments above helpful, and we would be pleased to discuss any aspect of the letter with the SEC or its staff.

Very truly yours,

/s/ Joshua M. Bloomstein

Joshua M. Bloomstein
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Ares Capital Corporation

cc: The Honorable Mary Jo White
The Honorable Kara M. Stein
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