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

30 March 2016

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

Dear Mr. Fields:

Ernst & Young LLP is pleased to comment on the *Use of Derivatives by Registered Investment Companies and Business Development Companies* proposal issued by the Securities and Exchange Commission (SEC or Commission). The proposal would create certain exemptions from existing restrictions on the issuance of senior securities by mutual funds, exchange-traded funds and closed-end funds, including business development companies (BDCs and, collectively, funds). It also would limit the use of derivatives and financial commitment transactions by the funds and require them to have assets available to meet the payment obligations in these transactions. In addition, certain funds would be required to establish formal derivatives risk management programs.

General

The stated objective of the proposal is to enhance investor protection by setting restrictions on the use of derivatives and financial commitment transactions by funds. In proposing Rule 18f-4 under the Investment Company Act of 1940 (the Act), the SEC said it was responding to growth in the volume and complexity of derivatives and their increased use by certain funds. If it finalizes the proposal, the SEC said it would rescind its Release No. 10666, *Securities Trading Practices of Registered Investment Companies*, and staff guidance addressing funds' use of derivatives and financial commitment transactions.

The proposing release indicates the Commission's view that a derivatives or a financial commitment transaction, as defined in proposed Rule 18f-4(c), involves the issuance of a senior security for purposes of Section 18 (or Section 61 in the case of BDCs) of the Act. The proposed rule, however, would provide an exemption from certain requirements of Section 18 and Section 61 and permit a fund to enter into such derivatives and financial commitment transactions provided the fund complies with certain conditions. For example, a fund relying on the proposed rule would not be required to

comply with Section 18's 300% asset coverage requirement (or Section 61's 200% asset coverage requirement in the case of BDCs) with respect to derivatives or financial commitment transactions.¹

Guidance on the senior securities table information

The proposed rule could affect certain registration statement and financial statement disclosures for closed-end funds, including BDCs (closed-end funds). Item 4.3 of Form N-2 (the registration statement used by closed-end funds) requires a registrant to include certain information for each class of its senior securities for the last 10 fiscal years (senior securities table), and such information must be audited for at least the last five fiscal years.² The information required to be presented in the senior securities table includes the total amount of senior securities outstanding excluding treasury securities, the asset coverage per unit and the average market value of senior securities per unit excluding bank loans. Closed-end funds may include the senior securities table in their audited financial statements.³ We believe the Commission should provide guidance on the effect of the proposal on such disclosures to ensure that closed-end funds disclose information consistently and users understand the disclosures.

If the Commission decides to adopt Rule 18f-4 as proposed, we recommend that the Commission provide guidance on whether a closed-end fund that would rely on the proposed exemption for derivatives and financial commitment transactions would be required to include such transactions as senior securities in its senior securities table disclosures (e.g., in the line item "Total amount of senior securities outstanding exclusive of treasury securities") or as a component of the calculations from which senior securities table disclosures are derived (e.g., asset coverage per unit and average market value of senior securities per unit excluding bank loans).

We believe that if a closed-end fund were to rely on this proposed exemption, the Commission should not require the closed-end fund to include derivatives or financial commitment transactions as senior securities in its senior securities table disclosures or as a component of the calculations from which

¹ Asset coverage is calculated in accordance with Section 18(h) of the Act, which defines "asset coverage of a class of senior security representing indebtedness of an issuer" as "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" and "asset coverage of a class of senior security of an issuer which is a stock" as "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.

² Instruction 8 to Item 4.1, which applies to Item 4.3, requires the financial highlights for at least the latest five fiscal years to be audited.

³ Instruction 4b to Item 24 of Form N-2 requires annual reports to shareholders required by Section 30(e) of the 1940 Act contain the financial highlights required by Item 4.1. We note that while the senior securities table is required by Item 4.3, certain closed-end funds include the senior securities table in the financial highlights in the audited financial statements. In the annual industry comment letter addressed to chief financial officers dated 14 February 2001, the staff of the SEC's Division of Investment Management indicated that one way to meet the senior securities table audit requirement is for a registrant to include the senior securities table information with the per-share and ratio information in the financial highlights. The staff also noted that since the financial highlights are specifically covered by the audit opinion, the senior securities table information also would be covered.

senior securities table disclosures are derived. We believe that when a closed-end fund calculates its asset coverage per unit, it should determine the amounts of open derivatives contracts and financial commitments as presented on the statement of assets and liabilities as of the end of its fiscal year in accordance with US GAAP and include any resulting assets as part of “total assets” and any resulting liabilities as part of “liabilities and indebtedness not represented by senior securities.” The Commission could require the closed-end fund to include disclosure indicating that although derivatives and financial commitments are senior securities, they would not be reflected as senior securities for purposes of the senior securities table disclosures and calculations because the closed-end fund would be relying on the exemption provided by proposed Rule 18f-4.

However, if the Commission disagrees and instead determines that, among other things, a closed-end fund relying on proposed Rule 18f-4 would include derivatives transactions and financial commitments as senior securities in the senior securities table and as components of calculations from which amounts in the senior securities table are derived, the Commission should clarify whether the amounts included for derivatives transactions would be based on their notional amounts, their mark-to-market liability if they are in a liability position as of the fiscal year end, or some other measure. The Commission also should clarify how, for the purposes of presenting the senior securities table information, a closed-end fund would treat its derivatives transactions that are in an asset position at the end of the fiscal year. Finally, the Commission should clarify for unfunded commitments, which are a type of financial commitment transaction, whether the obligation that would be funded if an unfunded commitment is fulfilled would be included as an asset for the purposes of determining “total assets” in the calculation of asset coverage per unit.

Auditor responsibilities

We recommend that the Commission reassess the need for the senior securities table included in a closed-end fund’s registration statement to be audited and consider eliminating this requirement.

When the audit requirement was adopted, funds’ investments and obligations were less complex than they are today and the determination of whether certain financial instruments met the definition of a *senior security* was generally more objective. Today, funds’ determinations whether certain of their financial instruments meet the definition of a senior security, and the amount of certain financial instruments that should be reflected as senior securities in the senior securities table, involve legal interpretations that are formed based on a consultation with (or opinion of) securities counsel. Accordingly, auditing the amounts included in the senior securities table has become more challenging over the years. While the proposed rule eliminates existing ambiguity with respect to whether certain derivatives and financial commitment transactions are senior securities, new challenges would be introduced, as we discuss further below, if the Commission does not rescind the audit requirement but instead takes certain actions as suggested earlier in our letter.

Furthermore, the requirement to separately audit a closed-end fund’s senior securities table in a registration statement filed on Form N-2 is unique within the fund industry, as the senior securities table is not otherwise required to be included in a fund’s audited financial statements under Commission rules or US GAAP. If the Commission were to eliminate the audit requirement, the senior securities table would still be subject to “another set of eyes,” as auditors would read the information in the senior securities table included in a registration statement in connection with procedures

required to be performed in accordance with Public Company Accounting Oversight Board (PCAOB) standards.⁴ Accordingly, we believe the senior securities table information should not be subjected to separate assurance or other audit procedures beyond those required by such standards.

If, however, the Commission decides not to rescind the audit requirement but were to clarify that a closed-end fund relying on proposed Rule 18f-4 would be able to exclude its derivatives and financial commitment transactions from certain disclosures in the senior securities table or from components of the calculations from which senior securities table disclosures are derived, we recommend that the Commission also clarify that an auditor's responsibility would not extend to evaluating a closed-end fund's compliance with the provisions of Rule 18f-4, when the auditor is auditing and reporting on the senior securities table information.

Generally, the auditor performs audit procedures on the senior securities table in connection with an audit of a closed-end fund's financial statements. The objective of the audit is to obtain reasonable assurance on whether an entity's financial statements are free of material misstatement and are presented in conformity with US GAAP. The auditor expresses an opinion on the entity's financial statements but does not opine on its compliance with regulatory requirements. Furthermore, certain conditions with which a closed-end fund would have to comply to rely on proposed Rule 18f-4 before entering into a derivatives transaction or financial commitment transaction during the year do not include objective criteria. For example, the risk-based coverage amount represents an estimate of an amount the fund would have to pay to exit the derivatives transaction under stressed conditions, and the value-at-risk (VaR) used to calculate a fund's full portfolio VaR and securities VaR is an estimate of potential losses on an instrument or portfolio over a specified period and at a given confidence interval. As a result, we believe that the extent of procedures performed by auditors with respect to a closed-end fund's compliance with the provisions of proposed Rule 18f-4 should be limited to gaining an understanding of the closed-end fund's policies and procedures for compliance and verifying that these policies and procedures have been approved by the fund's board.

If, however, the Commission disagrees and believes that an auditor's responsibility would extend to evaluating a closed-end fund's compliance with the provisions of Rule 18f-4 when the auditor is reporting on the senior securities table information, this would require the auditor to be engaged to perform additional procedures to assess the fund's compliance (or management's assertion regarding the fund's compliance) with the Rule (e.g., a compliance attestation engagement). Accordingly, the Commission should consider whether the benefits of conducting such an engagement would exceed the associated costs.

We note that we are also sending this letter to officials at the PCAOB and the American Institute of Certified Public Accountants (AICPA) to make them aware of our recommendations.

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⁴ See AU Section 711, *Filings Under Federal Securities Statutes* (AU 711). For example, paragraph .11 of AU 711 indicates that as part of subsequent events procedures in 1933 Act filings, the auditor generally should read the entire prospectus and other pertinent portions of the registration statement.



We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Very truly yours,

Ernst & Young LLP

Copies to: James R. Doty, Chairman, PCAOB
Lewis H. Ferguson, Board Member, PCAOB
Jeanette M. Franzel, Board Member, PCAOB
Jay D. Hanson, Board Member, PCAOB
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