SUTHERLAND

April 1, 2016

<u>Via Electronic Submission</u>

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

Re: Proposed Rule on Use of Derivatives by Registered Investment Companies and <u>Business Development Companies (File No. S7-24-15)</u>

Dear Mr. Fields:

We appreciate the opportunity to provide comments and offer suggestions on the SEC's proposed rule 18f-4 (the "***Proposed Rule***") under the Investment Company Act of 1940 (the "***Investment Company Act***").

Sutherland Asbill & Brennan LLP is an international law firm with offices in Atlanta, Austin, Geneva, Houston, London, New York, Sacramento and Washington, DC. We have represented business development companies ("***BDCs***") for more than 20 years and maintain the nation's pre-eminent practice in all aspects of the formation, operation and regulation of BDCs. We currently have a large, dedicated team of attorneys who spend all or most of their time on BDC matters. The comments contained in this letter reflect the collective views of our firm and the following BDC clients of ours:

- Business Development Corporation of America,
- Capitala Finance Corp.,
- Credit Suisse Park View BDC, Inc.,
- Fidus Investment Corporation,
- Harvest Capital Credit Corporation,
- Main Street Capital Corporation,
- Medley Capital Corporation,
- New Mountain Finance Corporation,
- PennantPark Floating Rate Capital Ltd.,
- PennantPark Investment Corporation,
- Rand Capital Corporation,
- Saratoga Investment Corp.,
- Sierra Income Corporation,
- Solar Capital Ltd.,
- Solar Senior Capital Ltd.,
- THL Credit, Inc.,

- Triangle Capital Corporation and
- TriplePoint Venture Growth BDC Corp.

I. Background

At the outset, we would like to highlight that our comments focus only on the regulation of unfunded commitments under the Proposed Rule and the Investment Company Act. In this regard, we have assumed that BDCs would be required to either segregate assets to cover unfunded commitment transactions in accordance with the Proposed Rule or account for unfunded commitments as senior securities in accordance with the asset coverage requirement under the Investment Company Act if the Proposed Rule is adopted in its current form.[1]

In the context of BDCs, unfunded commitments are contractual obligations to extend credit to or make an equity investment in a company. Unfunded commitments of BDCs can arise in a number of investment scenarios, including:

- senior secured revolving credit facilities;
- delayed draw term loans;[2] and
- capital commitments to private investment funds.[3]

These unfunded commitments are not designed for speculative purposes or to accomplish leveraging. Rather, much like a bank that offers its customers revolving lines of credit, delayed draw term loans and other sources of financing, BDCs offer various forms of financing, including revolving lines of credit and delayed draw term loans, to portfolio companies in order to, among other things, satisfy their working capital needs and forge strong ongoing relationships with them. BDCs generally offer to provide unfunded commitments to portfolio companies in

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[1] Neither the Proposed Rule nor the related proposing release clearly discusses the consequences of a BDC failing to comply with the asset segregation requirement of the Proposed Rule for some or all of its unfunded commitment transactions. However, in the event that the SEC seeks to take the position at some point in the future that such uncovered unfunded commitments should be treated as senior securities under the Investment Company Act, we thought it would be prudent for us to offer some preliminary comments on this potential position prior to the SEC seeking to do so. More importantly, and as discussed in more detail elsewhere herein, we believe that the SEC should only seek to do so after obtaining input from BDCs and other concerned parties through the rulemaking process.

[2] A delayed draw term loan allows a borrower to draw down amounts under the loan at predefined times and/or upon the occurrence of specified events.

[3] Pursuant to Section 55(a) of the Investment Company Act, a BDC must generally have at least 70% of its total assets in investments made to private U.S. operating companies. Thus, no more than 30% of a BDC's total assets generally may be invested in private investment funds and, as a result, capital commitments to private investment funds do not generally comprise a significant portion of the outstanding unfunded commitments of BDCs.

connection with the provisions of other forms of financing and often offer them during the term sheet phase of the investment process in order to assist the portfolio companies in assessing various financing alternatives.

Unfunded commitments provide a BDC's portfolio companies with access to additional capital allowing those companies to grow their businesses with the assurance that they will have a source of funding available as demand for their products and services grow. We believe that the regulation of unfunded commitments under the Proposed Rule or under the asset coverage requirement of the Investment Company Act would have harmful unintended consequences for BDCs and their portfolio companies. Therefore, we encourage the SEC to consider our comments in connection with this rulemaking process and any future rulemaking process relating to the treatment of unfunded commitments as senior securities under the Investment Company Act.

II. General Comment

Congress enacted the Small Business Investment Incentive Act of 1980 (the "***SBII Act***") in response to a perceived crisis that took place in the capital markets in the 1970s.[4] Congress passed the SBII Act based, in part, on its recognition that BDCs could provide an important source of capital to an illiquid, but important, segment of the U.S. economy (i.e., private companies).[5] As such, Congress designed a statutory framework intended to reduce the regulatory burden on companies "whose principal activities consist of investing in . . . [private U.S.] businesses."[6] The goal of this framework was to "remove burdens on [investment] activities that might create **unnecessary disincentives** to the legitimate provision of capital to [private U.S.] businesses."[7] For example, Congress allowed BDCs to use more leverage than traditional open-end and closed-end funds.[8]

In exchange for relieving BDCs from certain burdensome provisions of the Investment Company Act, Congress required BDCs to invest a significant amount of their assets in certain types of investments. Specifically, Congress effectively required BDCs to invest at least 70% of the value of their total assets in "eligible portfolio company assets," which include the securities of U.S. operating companies that are non-public or thinly traded.[9] Congress also defined eligible

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4 *See*, Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2274 (Oct. 21, 1980).

5 H.R. Rep. No 96-1341, at 21-22 (1980)

6 *Id*. at 2 (1980).

7 *Id*. at 22 (emphasis added).

8 *Compare* Investment Company Act, Section 18(a)(1)(A) and (B) *with* Investment Company Act, Section 61(a)(1).

9 *See* Investment Company Act, Sections 2(a)(46) and 55(a).

portfolio company assets to include the securities of financially distressed U.S. companies to encourage BDCs "to provide financial and managerial assistance to a deeply troubled company before its circumstances are so dire that it must seek protection through formal bankruptcy proceedings."[10] BDCs have thus far ably fulfilled their Congressional mandate, providing over $70 billion in financing to U.S. middle-market businesses.[11] This financing has helped U.S. businesses expand and create jobs in an environment in which traditional financing has become increasingly difficult for such businesses to attain as a result of, among other things, the continued shift by banks toward larger borrowers.[12] The flexibility provided by financing structures such as revolving lines of credit and delayed draw term loans, are, we believe, critically important in meeting the capital needs of these U.S. businesses.

We believe that it would be inconsistent with the Congressional intent underlying the SBII Act to subject unfunded commitments, such as revolving lines of credit and delayed draw term loans, to either the constraints that would be imposed under the Proposed Rule or treatment as senior securities under Section 18(a), as modified by Section 61, of the Investment Company Act ("***Section 18***").[13] Either of these actions would hinder the primary purpose of the SBII Act by creating an **unnecessary disincentive** to providing capital to companies that already have limited access to conventional funding. In particular, when Congress enacted the SBII Act in 1980, it was aware of Investment Company Act Release 10666[14] ("***Release 10666***") (discussed below), which the SEC issued in 1979 and serves as the basis for the SEC's position to regulate unfunded commitments under the Proposed Rule, and could have applied that guidance to BDC unfunded commitments if it had intended to do so.

Most importantly, unfunded commitments do not share the attributes of senior securities that the SEC set forth in Release 10666 or that are typically associated with senior securities as contemplated under Section 18. In Release 10666, the SEC opined that, although not included in the statutory definition of a senior security, certain trading practices of investment companies "may involve the issuance of a senior security subject to the prohibitions and asset coverage requirements of Section 18."[15] Specifically, the SEC stated that certain investment company

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10 H.R. Rep. No 96-1341. at 42 (discussing the purpose of Section 55(a)(3) of the Investment Company Act).

11 *See* Small Business Investor Alliance: BDC Modernization Agenda, Legislative Recommendations for Members of the 114th Congress, *available at* http://c.ymcdn.com/sites/www.sbia.org/resource/resmgr/Government_Relations/2015_SBIA_BDC_Agenda_Web.pdf.

12 According to S&P LCD's Leverage Lending Review 2014, the participation of banks in the loan market for below investment grade borrowers declined from 70% in 1994 to just over 10% in 2013.

13 Section 18 of the Investment Company Act defines a "senior security" in part, as ''any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness . . . ."

14 Investment Company Act Release 10666, "Securities Trading Practices of Registered Investment Companies" 44 Fed. Reg. 25,128 (April 18, 1979).

15 *Id.* at 25,129.

trading practices were the economic equivalents to taking out loans (reverse repurchase transactions), issuing puts (standby commitment agreements), or creating "unlimited leverage" because the transaction involved "the potential for profit or loss without any investment" due to interest rate fluctuations (firm commitment transactions). While the SEC noted that the trading practices discussed in Release 10666 may not be considered securities for all purposes, it found that investment companies used such practices "for speculative purposes or to accomplish leveraging," which fell within the legislative purpose of Section 18.[16]

Unlike the trading practices discussed in Release 10666, unfunded commitments are not entered into by BDCs for speculative purposes, and such transactions do not accomplish leverage for the BDC. To the contrary, BDCs offer their portfolio companies unfunded commitments, such as revolving credit facilities and delayed draw term loans, in order to forge strong business relationships with the portfolio companies and provide them with flexible financing solutions tailored to their needs. Like most businesses, BDC portfolio companies need financing solutions that provide liquidity on which they can draw down to fund their operations when they experience temporary cash flow shortfalls, including business expenses like payroll or weekly purchases, or in connection with planned capital outlays for fixed assets, etc. The unfunded commitments that BDCs provide satisfy these needs.

In addition, BDCs generally provide unfunded commitments to portfolio companies in connection with existing lender-borrower relationships (e.g., the BDC has a senior secured term loan investment in the portfolio company) as a way to protect the BDC's first lien position. If the BDC did not provide these other lending services to its portfolio companies, then banks and other debt providers would have to provide such working capital lines of credit and would require a first lien on some or all of the assets of the portfolio companies. In such event, the BDC would be required to subordinate its first priority lien to such other debt providers, thereby resulting in the BDC being paid behind these debt providers in the event of a foreclosure of the collateral. The addition of another senior lender in connection with a portfolio company investment made by a BDC also means that the BDC loses the ability to control the outcome of any restructuring involving the portfolio company. Given that the BDC may have other investments in the portfolio company to protect, such as second lien loans and equity investments, losing such control could be detrimental to the BDC's overall investment in the portfolio company.

The attributes and features of unfunded commitments, such as senior secured revolving credit facilities and delayed draw term loans, that BDCs provide to their portfolio companies are deliberately designed to avoid interest rate risk, confirming that BDCs do not enter into these arrangements for "speculative purposes or to accomplish leveraging." These instruments typically have floating interest rates and interest rate floors and, as a result, the payments made by portfolio companies to BDCs thereunder adjust in correlation to interest rate changes (subject to any interest rate floor). While these features may not completely eliminate interest rate risk

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[16] *Id.* at 25,131.

with respect to these instruments, they do significantly mitigate such risk and, as a result, do not contain the significant speculative attributes associated with the securities trading practices discussed in Release 10666.

A BDC's unfunded commitments do not bear any economic similarity to leverage because the fees associated with an unfunded commitment are intended to defray the administrative and underwriting costs associated therewith, not to compensate the BDC for extending credit. Thus, unlike the standby commitment agreements discussed in Release 10666, these unfunded commitments are not being used to "earn commitment fees without revenue or cost." Moreover, the fees that BDCs receive from these instruments are used not as "puts" to enable them to earn fees without investment or cost; rather, BDCs use these fees to defray administrative and underwriting costs associated therewith. As a result, BDCs receive such fees in exchange for the cost of providing their portfolio companies with access to capital in the form of senior secured revolving credit facilities and delayed draw term loans, not as a means of earning a significant source of income unaccompanied by any actual cost to or investment by BDCs.

In light of the foregoing, we believe that subjecting unfunded commitments to regulation under the Proposed Rule or treating them as senior securities under Section 18 is inconsistent with the legislative purpose behind the creation of BDCs and the concerns underlying Section 18, as well as the policy rationale underlying Release 10666. As a result, we believe that the SEC should specifically exclude unfunded commitments of BDCs from regulation under the Proposed Rule and not seek to treat them as senior securities under the Investment Company Act in connection with any future rulemaking or otherwise.[17]

II. Specific Comments

If the SEC does not follow our recommendation set forth above, we believe that it should revise the Proposed Rule in the following manner.

A. The Proposed Rule Should Give BDCs the Discretion to Determine which Unfunded Commitments Need to be Covered as Opposed to Dictating Strict Asset Coverage for All Unfunded Commitments

Although the Proposed Rule provides substantial deference to the boards of directors and management of BDCs in connection with various determinations required thereunder, it provides a one-size-fits-all approach to determining what assets must be covered. This aspect of the Proposed Rule is inconsistent with the fact that the financial risks associated with BDC unfunded commitments vary depending on the contractual provisions governing and facts surrounding the particular unfunded commitment. Rather than mandating that BDCs fully cover all unfunded

[17] In the event that a BDC fails to comply with the asset segregation requirement of the Proposed Rule for some or all of its unfunded commitment transactions for whatever reason, we believe that the only consequence thereof should be that the BDC should be prohibited from entering into new any financial commitment transactions until it comes into compliance with the asset segregation requirement under the Proposed Rule.

commitments, regardless of the particulars of an unfunded commitment, the SEC should give BDCs the discretion to identify and evaluate which unfunded commitments present a risk that should be subject to asset segregation.

A BDC's management, with oversight from its board of directors, is in a better position than the SEC to assess the specific risks associated with the BDC's unfunded commitments, and would have a duty to fairly and accurately account for the risks associated with unfunded commitments. If given the discretion to make such a determination, the BDC's management and, in connection with its oversight responsibilities, board of directors would have a fiduciary obligation to identify and evaluate the risks associated with the BDC's unfunded commitment transactions and require that the BDC have sufficient assets to cover those unfunded commitments that pose a risk. We believe that the central role that BDC boards of directors play in the determination of the fair value of the illiquid investments of BDCs, including the principles used by them in connection therewith, would aid BDC boards of directors in overseeing management's determinations of how to properly assess the particular facts and related liquidity risks associated with each unfunded commitment and ensure that those risks are properly covered through asset segregation. This flexibility would allow BDCs to continue to provide capital to private U.S. companies, such as small and midsize U.S. energy companies which are currently facing a "gigantic funding crisis" as a result of banks "clamping down on the ability of oil and gas companies to tap credit lines,"[18] while requiring that the BDC's management, with oversight from its board of directors, monitor the nature and quantity of the BDC's unfunded commitments, as well as mandate asset segregation requirements with respect thereto when and in such amounts as the BDC's management deems appropriate.

B. The SEC Should Confirm that Discretionary Unfunded Commitments are not Subject to the Proposed Rule

The Proposed Rule would require asset segregation for any "agreement under which a [BDC] has obligated itself, conditionally or unconditionally, to make a loan to a company or to invest equity in a company, including by making a capital commitment to a private fund that can be drawn at the **discretion** of the fund's general partner"[19] and, thus, subject it to an asset segregation requirement. In the proposing release relating to the Proposed Rule (the "***Proposing Release***"), the SEC reasoned that the existence of an unfunded commitment exposes a BDC to risks "in that the [BDC] may be required to liquidate other assets of the [BDC] to obtain the cash needed by the [BDC] to satisfy its obligations, and if the [BDC] is unable to meet its obligations, the [BDC] would be subject to default remedies available to its counterparty."[20] This rationale

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[18] *See* The Wall Street Journal, March 25, 2016, at page A1.

[19] Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,884, 80,900 (Dec. 2015) (emphasis added).

[20] *Id*.

apparently is based on the assumption that all unfunded commitments may be drawn at the discretion of the third-party thereunder.[21]

However, the Proposed Rule fails to take into account the fact that, in certain transactions, a BDC's funding obligation is subject to the BDC's approval. In these transactions, which would appear to be subject to the Proposed Rule, the BDC is not subject to any risk related to non-performance. For example, some BDC revolving loan agreements include "consent rights" pursuant to which the BDC has the sole discretion to determine whether to fund the loan upon the request thereof by the borrower. Other BDC unfunded commitments, like capital commitments to private investment funds jointly managed by the BDC, may not be drawn upon without the BDC's specific approval or consent. These transactions should not be subject to asset segregation under the Proposed Rule because the BDC faces no financial or liquidity risks unless it agrees to fund the commitment. Accordingly, the SEC should specifically confirm in the final 18f-4 rule (the "***Final Rule***") that "unfunded commitments" which are contractually or otherwise subject to, or are within, the BDC's discretion to fund are not covered by the Proposed Rule.

C. The Proposed Rule Should Treat Non-Discretionary Conditional and Unconditional Unfunded Commitments Differently Because Their Divergent Characteristics Create Different Liquidity Risk Profiles

The Proposed Rule provides that all unfunded commitments would be subject to the same asset segregation requirement, irrespective of whether a BDC's obligation to fund the unfunded commitment is conditional. However, we believe that the Proposed Rule should reflect the differing characteristics and liquidity risks between non-discretionary conditional and unconditional unfunded commitments. In the case of a non-discretionary conditional unfunded commitment, the BDC will only become obligated to fund after all of the conditions thereunder have been fulfilled (i.e., after one or more specified uncertain future events have occurred). As a result, the counterparty to the non-discretionary conditional unfunded commitment will not have a right to request funding thereunder until these conditions have been met. Examples of such conditions include:

- the receipt of certain specified regulatory approvals;
- the closing of a pre-defined acquisition of another entity or business;
- the achievement of a pre-defined measure of financial performance;
- the receipt of specified third-party equity or other financing, including the amount thereof; and
- the passage of a specified period of time or the occurrence of a specific date.

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21 *See id.*

In the event that the specified conditions have not been satisfied prior to the unfunded commitment's termination date, the BDC will be released from any further obligations to provide funding. In contrast, a non-discretionary unconditional unfunded commitment creates an immediate obligation for the BDC to fund at any time after its entry into such arrangement upon the request of the counterparty.

Because of its conditional nature, the liquidity risk associated with a non-discretionary conditional unfunded commitment is not ripe until the specified conditions have occurred. Meanwhile, liquidity risk is present at the inception of a non-discretionary unconditional unfunded commitment. In this regard, we note that the SEC's primary concern relating to unfunded commitments stems from the fact that "if the [BDC] is unable to meet its [unfunded commitment] obligations [because it does not have sufficient liquidity to do so], the [BDC] would be subject to default remedies available to its counterparty."[22] Since non-discretionary conditional unfunded commitments do not involve liquidity risk or risks relating to the BDC being subject to default remedies until the occurrence of one or more uncertain future events, and non-discretionary unconditional unfunded commitments involve immediate liquidity risk and risks relating to the BDC being subject to default remedies, we believe that non-discretionary conditional unfunded commitments should not be subject to the asset segregation requirement under the Proposed Rule until such time that there is a substantial likelihood that the conditions to funding will be met.

We believe that the standard for determining whether there is a substantial likelihood that the conditions of funding will be met should be whether the BDC has sufficient advance knowledge or notice of when the conditions will occur or be satisfied. Specifically, this advance knowledge or notice may be derived from, among other things, the BDC's informational and other contractual rights relating to the unfunded commitment counterparty (e.g., board representation/observer rights), third-party sources (e.g., a government agency's publication of a notice regarding an impending regulatory approval) or through a contractual provision that provides that the BDC will only become obligated to fund a loan or an equity investment a specified period of time after the borrower has notified the BDC of the borrower's satisfaction of the conditions precedent to any required funding thereunder by the BDC.

As with other aspects of the Proposed Rule, we believe that the boards of directors of BDCs should be required to approve policies and procedures with respect to the standard for determining whether there is a substantial likelihood that the conditions to the funding of a conditional unfunded commitment will be met. More specifically, these policies and procedures would address the following matters:

- the circumstances in which the BDC will be deemed to have advance knowledge or notice of the satisfaction of conditions precedent to a funding obligation by the BDC and

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22 *See* Proposing Release at 80,900.

- the minimum time period before funding by which the BDC needs to obtain such advance knowledge or notice in order for it to have an appropriate lead time to ensure that it will have (or can arrange to have) the necessary liquidity to fund the conditional unfunded commitment when it is legally required to do so.

We believe that this approach adequately addresses the SEC's concerns relating to the liquidity risk posed by non-discretionary conditional unfunded commitments by requiring a BDC to comply with the asset segregation requirement under the Proposed Rule relating thereto unless the BDC determines that it will have sufficient advance knowledge or notice pertaining to when the conditions thereunder will occur or be satisfied. Such determination would be made by the BDC's management pursuant to policies and procedures approved by the BDC's board of directors. In the event that the BDC determines that it will have sufficient advance knowledge or notice pertaining to when the conditions under non-discretionary conditional unfunded commitments will occur or be satisfied, the BDC would be required to comply with the asset segregation requirement once it has received such advance knowledge or notice. This approach would eliminate the imposition of unnecessary regulatory and financial burdens on BDCs and their stockholders arising from BDCs having to hold cash and cash equivalents or other assets to cover non-discretionary conditional unfunded commitments prior to the time that such commitments pose any real liquidity risk to BDCs.

D. The SEC Should Expand the Definition of "Qualifying Coverage Assets" Consistent with the Approach Taken in Proposed Rule 22e-4

The Proposed Rule defines a "qualifying coverage asset," in respect of an unfunded commitment, as BDC assets that are, in pertinent part:[23]

- Cash and cash equivalents; or
- 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, determined in accordance with policies and procedures approved by the fund's board of directors.

Importantly, the Proposed Rule does not define the specific assets that could be deemed to be "assets that are convertible to cash or that will generate cash" but, rather, leaves the determination to a BDC's management, with oversight by its board of directors. As noted in our comments above, we support this approach and note the SEC's statement in the Proposing Release that:

[23] Proposed Rule 18f-4(c)(8).

> "[b]y requiring [BDCs] to establish appropriate policies and procedures, rather than prescribing specific segregation methodologies, the proposed rule is designed to allow [BDCs] to assess and determine when they can be required to pay [unfunded commitments] and their assets' convertibility to cash or ability to generate cash based on the [BDCs'] specific financial commitment transactions and investment strategies."[24]

In light of that statement, it seems appropriate, as suggested by the SEC, to incorporate in the Final Rule the factors and guidance in proposed Rule 22e-4 ("***Proposed Rule 22e-4***") under the Investment Company Act,[25] which are designed to guide a BDC when assessing the convertibility of a fund's assets into cash.[26] Specifically, Proposed Rule 22e-4 would require a fund to consider its cash and cash equivalent holdings, as well as its borrowing arrangements and other funding sources, in assessing its liquidity risk.[27]

In this regard, many BDCs maintain one or more committed revolving credit facilities with large financial institutions. We believe that the SEC should permit a BDC to count the borrowing capacity available under committed revolving credit facilities and other committed funding sources[28] when determining whether it has sufficient "assets" to cover its unfunded commitments. In the proposing release relating to Proposed Rule 22e-4, the SEC specifically acknowledged that "it was relatively common for funds to establish lines of credit to manage liquidity risk."[29] In connection with Proposed Rule 22e-4, the SEC also provided guidance which suggested that it is appropriate for funds to consider borrowing availability under committed lines of credit in addressing liquidity concerns.[30] As a result, we believe that the Final Rule should allow BDCs to use their committed revolving credit facilities and other committed funding sources as a "qualifying coverage asset" to the extent of the available borrowing capacity thereunder.

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[24] Proposing Release at 80,929.

[25] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, 80 Fed. Reg. at 62,304 (Dec. 2015)

[26] *See id*.

[27] *See id.* at 62,305

[28] Examples of other funding sources may include equity lines of credit or capital commitments. Under an equity line of credit, a BDC enters into an agency agreement with an investor pursuant to which the BDC has the right, during the term of the equity line and subject to certain conditions, to sell its securities to the investor. Also, although not common in the BDC space, a number of so-called "private" BDCs (i.e., BDCs that sell their shares through private placement offerings from the date of their inception and for a period of time thereafter, but which intend to conduct a public offering of their securities at some point in the future) use the capital commitment model.

[29] *Id.* at 62,320.

[30] *Id.* at 62,320-62,321.

E. The SEC Should Only Require BDCs to Determine Their Compliance with the Asset Segregation Requirement under the Proposed Rule Upon the Occurrence of Certain Defined Events Consistent with Section 18

We believe that it would be inconsistent with Section 18 to require that BDCs determine their compliance with the asset segregation requirement under the Proposed Rule on a daily basis. The 200% asset coverage requirement set forth in Section 18 is a transactional one, meaning that the BDC is required to comply with the provisions of Section 18 any time the BDC seeks to incur additional indebtedness or upon the occurrence of certain other events. Specifically, Section 18 provides that it is unlawful for a BDC to issue any class of senior security unless immediately after such issuance the BDC will have at least 200% asset coverage. Similarly, BDCs cannot declare a dividend or distribution on their common stock under certain circumstances if they will not have a 200% asset coverage ratio after deducting the amount of such dividend or distribution.

Therefore, consistent with existing regulations governing BDCs, we believe that the Proposed Rule should only require that BDCs determine whether their qualifying coverage assets cover their unfunded commitments on a transactional basis. This transactional standard would require a BDC to determine that it has qualifying coverage assets to cover its unfunded commitments before it engages in any of the following: (i) enters into a derivative transaction, financial commitment transaction or a transaction subject to the asset coverage requirement of Section 18[31] and (ii) declares a common stock dividend or distribution. We believe that our proposed approach would fully afford the protections that the SEC is seeking to implement without imposing a requirement that significantly departs from the current regulatory regime under which BDCs operate.

F. The SEC Should Seek Input Through the Rulemaking Process Prior to Mandating that Unfunded Commitments be Treated as Senior Securities under the Investment Company Act if a BDC is Unable to Comply with the Proposed Rule

Neither the Proposed Rule nor the Proposing Release clearly discusses the consequences of a BDC failing to comply with the asset segregation requirement of the Proposed Rule for some or all of its unfunded commitment transactions. However, in the event that the SEC seeks to take the position at some point in the future that such uncovered unfunded commitments should be treated as senior securities subject to the asset coverage requirement (the "***Asset Coverage Requirement***") under Section 18, we believe that it should seek input through the formal rulemaking process before doing so in order to satisfy due process concerns as well as afford BDCs the opportunity to comment on the contours of such a rule. For example, we

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[31] The terms "derivate transaction" and "financial commitment transaction" have the meanings ascribed to them in the Proposed Rule.

believe that BDCs would likely want the rule to include guidance specifically acknowledging the appropriateness of the following practices thereunder:

- In the event that a BDC is required to treat some or all of its unfunded commitments as senior securities for purposes of the Asset Coverage Requirement, then the BDC would increase the numerator (i.e., the BDC's total assets less all liabilities and indebtedness not represented by senior securities) and the denominator (i.e., the amount of the BDC's senior securities representing indebtedness) in connection with calculating its compliance with the Asset Coverage Requirement in an amount equal to the BDC's unfunded commitments that are treated as senior securities for purposes of the Asset Coverage Requirement. The rationale for such approach is that if the BDC is being required to treat unfunded commitments as senior securities (i.e., outstanding indebtedness) or has elected to do so, then it should be able to similarly treat such commitments as having been funded and, as a result, as outstanding assets for purposes of calculating its compliance with the Asset Coverage Requirement.[32]

- A BDC would be permitted to go back and forth between covering an unfunded commitment in accordance with the Final Rule and treating it as a senior security under the Asset Coverage Requirement on each date that a determination relating to asset segregation/asset coverage is required to be made by the Final Rule or the final rule requiring it to treat the uncovered unfunded commitments as a senior securities under the Asset Coverage Requirement.

In addition, we believe that BDCs may wish to have the option to treat some or all of their unfunded commitments as senior securities under the Asset Coverage Requirement depending on the parameters of the final rule mandating or permitting the same. This is particularly important for BDCs given the fact that the asset segregation requirement under the Proposed Rule may have a significant adverse effect on the investment return and earnings of BDCs as a result of the requirement that they hold significant cash and cash equivalents or other asset balances relating thereto. We note that both segregating assets to cover unfunded commitments and treating unfunded commitments as senior securities equally serve to ensure that a BDC is maintaining sufficient liquidity to meet its obligations pursuant to unfunded commitments.

For these reasons and other reasons, we believe that the SEC should seek input through the rulemaking process prior to adopting a rule that treats or allows BDCs to treat unfunded commitments as senior securities under the Asset Coverage Requirement.

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[32] *See* Report, dated June 26, 2015, issued by Jonathan Bock and Finian O'Shea of Wells Fargo Securities, LLC – Equity Research Department at 2 ("What's more, there's a legal argument against simply adding the liabilities to the denominator total assets calculation namely that A BDC WOULD NEVER FUND THE COMMITMENT AND NOT HAVE A CORRESPONDING ASSET. As a result, if we were to be fair and include these contingent liabilities in the denominator of the asset coverage test, WE MUST ALSO BE WILLING TO ADD THE SAME TO THE NUMERATOR.").

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Thank you for considering our views on this important topic to BDCs. If the SEC or its staff wishes to discuss the matters mentioned in this letter, please contact Harry S. Pangas at [redacted] or [redacted] or Lisa A. Morgan at [redacted] or [redacted].

Respectfully yours,

SUTHERLAND ASBILL & BRENNAN LLP