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April 8, 2016

Mr. Brent J. Fields
Secretary
United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Mr. Fields:

This letter is submitted on behalf of the Federal Regulation of Securities Committee (the "Committee" or "we") of the Section of Business Law of the American Bar Association (the "ABA"), in response to the request for comment by the U.S. Securities and Exchange Commission (the "Commission") presented in the proposing release referenced above (the "Proposing Release"). As set out in the Proposing Release, the Commission has proposed new Rule 18f-4, which would, among other things, (a) modify the current asset segregation requirements for registered open-end and closed-end companies and business development companies (collectively, "Funds") that use derivatives, (b) require Funds to comply with portfolio limitations that would restrict their use of derivatives compared with the current regime and (c) require many Funds to adopt and implement written derivatives risk management programs.

Members of the Committee regularly advise investment companies and their directors with respect to matters arising under the Investment Company Act of 1940, as amended (the "1940 Act"). The comments in this letter (this "Comment Letter") represent the views of the Committee only and have not been approved by the ABA's House of Delegates or Board of Governors and, therefore, do not represent the official position of the ABA. In addition, this Comment Letter does not represent the official position of the Section of Business Law of the ABA.

The Committee thanks the Commission for this opportunity to comment on the Proposing Release. Set out below is a general summary of the Committee's views, followed by specific comments related to the Proposing Release.

Summary of Comments

We believe the Commission can achieve its public policy objectives without the need to impose specific numeric limitations on the use of derivatives. Coverage and segregation requirements have worked well for many years as a practical limitation on the amount of risk that a Fund may take and should, in our view, continue to be the primary tool for addressing the use of derivatives by Funds.

Portfolio limitations – of any kind and set at any level – appear to us to be inconsistent with the legal framework reflected in Investment Company Act Release No. 10666 ("Release 10666"),[1] and the long line of Staff guidance based on Release 10666, in which the Commission and its Staff advised that it would not raise a senior security issue if the relevant Fund obligation is "covered" by segregated assets. The proposed portfolio limitations, based on gross notional amounts, appear to lack a sufficient connection to the leverage concerns that they purport to address. Some industry participants have commented that the data on which the Commission relied in formulating the proposed portfolio limitations is flawed and the proposed limitations appear to be unduly restrictive. Given the breadth of the proposed rulemaking, the reversal of precedents, and the evident importance of the data to the Commission's understanding of relevant market structure and impacts, any concerns with the data warrant careful attention. To the extent that the Commission is committed to imposing portfolio limits on Funds' use of derivatives, we suggest an alternative approach, under which different portfolio limitations would apply to derivatives in different asset classes.

We believe that the Commission's final rule should permit Funds to cover their obligations in relation to derivatives with a far greater range of liquid assets than those permitted by the proposed Rule 18f-4, which narrowly limits the types of assets that a Fund may segregate in connection with its derivatives positions. In our view, the Commission's final rule should be consistent with current practice, under which Funds may use a wide range of liquid assets to cover their obligations. If that is not the case, then in many cases Funds will simply be unable to enter into derivatives transactions and/or will hold more cash and government securities than is otherwise appropriate to their strategies, outcomes that often will be contrary to shareholder interests.

We are concerned that the definition of "financial commitment transaction" contained in the proposed rule is overly broad and may include transactions that do not raise any of the concerns that the proposed rule is intended to address. Specifically, that definition includes conditional obligations to make a loan or equity investment, even if the condition is entirely within the control of the Fund. We believe that such conditional obligations should be expressly excluded from the "financial commitment transaction" definition.

We believe that, as drafted, the proposed rule would interfere with the intended function of business development companies ("BDCs") as a source of capital for small

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[1] Securities Trading Practices of Registered Investment Companies, Investment Company Act. Release No. 10666 (Apr. 18, 1979), codified at 44 Fed. Reg. 25128 (Apr. 27, 1979).

and medium-sized U.S. businesses. Congress intended BDCs to be able to incur leverage greater than that permitted for other types of registered funds. Permitting BDCs to incur more debt than other registered funds provides BDCs with easier access to capital and serves the statutory goal of increasing capital access to smaller businesses. Accordingly, BDCs should have a greater ability to engage in transactions such as derivatives and reverse repurchase agreements than other types of funds, consistent with Sections 18 and 61 of the 1940 Act. The proposed rule would also interfere with the intended function of BDCs by requiring them to segregate assets against BDCs' unfunded obligations to make loans, again undermining congressional intent.

We are concerned that the tasks that the proposed rule allocates to a Fund's board of directors ("Board") would require the Board to go beyond its traditional oversight role and move closer to the role of an investment manager. We ask that the Commission assess carefully whether Boards should be so deeply involved in matters in which they will inevitably be required to rely upon investment advisers or third-party consultants. Further, we urge the Commission to confirm that it does not intend any final version of the proposed rule to change the relevant legal standards applicable to Board oversight of Funds and their investment advisers.

Finally, it is evident to us that the Proposing Release has inspired a significant amount of comment and concern in the investment management community. We understand that industry members will offer comments suggesting different portfolio limitations than those contained in the Proposing Release. Assuming the Commission agrees with us or with the many other commenters suggesting material modification of the proposed rule, given the complexities and sensitivities of the issues, we strongly encourage the Commission to re-propose the rule and permit further public comment.

Asset Segregation Requirements by Themselves Are Adequate to Protect Against Excessive Leverage

Proposed Rule 18f-4 contains two proposed derivatives portfolio limitations for Funds; each Fund would be required to adhere to one of the two limitations. Under the first portfolio limitation, a Fund's aggregate exposure as a result of its derivatives positions, measured by notional amount, could not (along with the Fund's obligations under certain other transactions) exceed 150% of the value of the Fund's net assets. Under the second, "risk-based," portfolio limitation, a Fund's aggregate exposure to derivatives, measured by notional amount, could not (along with the Fund's obligations under certain other transactions) exceed 300% of the value of the Fund's net assets and, in addition, the Fund's derivatives would be required to reduce its overall "Value-at-Risk." We believe that the longstanding asset segregation requirements of the Commission and its Staff are sufficient to protect investors, and thus that the proposed portfolio limitations are unnecessary. We respectfully ask the Commission to reconsider and abandon the limitations.

We noted previously, in our 2010 task force report (the "Task Force Report"),[2] that we believe existing practice, built around almost 40 years of established Commission and Staff positions giving primacy to an asset segregation approach, is the appropriate starting point to address Funds' use of derivatives. The Commission first set forth its asset segregation requirements in Release 10666, which did not specifically address derivatives but focused on reverse repurchase agreements, firm commitment agreements, and standby commitment agreements. In Release 10666, the Commission stated that, if a Fund "covered" its obligations under such transactions, no issue of compliance with Section 18 would be raised. Release 10666 explained that a Fund could "cover" a transaction by maintaining segregated assets sufficient to satisfy 100% of the Fund's obligations under the transaction. As a practical matter, as we discuss below, the obligation to segregate assets placed a ceiling on the amount of leverage a Fund could employ. Release 10666 has been widely understood and interpreted, including by the Staff,[3] to mean that, if a Fund meets applicable segregation requirements, no senior security is present.

As we noted in the Task Force Report, the Staff's later guidance regarding asset segregation left certain matters ambiguous, including, in certain cases, the amount of assets to be segregated. Despite such matters, however, we believed at the time of the Task Force Report, and continue to believe, that the basic framework articulated in Release 10666 has worked well. We are not aware of any Fund that has entered into derivatives transactions and complied with current asset segregation requirements but has nonetheless defaulted on payments in respect of senior securities or otherwise caused problems for itself, its shareholders or its derivatives counterparties by reason of its use of derivatives. The existing asset segregation framework works well because it functions as it was intended to function: assuming a Fund complies with the asset segregation requirements, the Fund faces an inevitable check on its activities. If a Fund's derivatives transactions become sufficiently out-of-the-money to the Fund, then,

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[2] Report of the Task Force on Investment Company Use of Derivatives and Leverage, Committee on Federal Regulation of Securities, ABA Section of Business Law, July 6, 2010, *available at* https://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf. The Task Force was formed, and this Report prepared, in response to a request from the then-Director of the Division of Investment Management, Andrew Donohue. In response to the Commission's subsequent concept release, "Use of Derivatives by Investment Companies under the Investment Company Act of 1940, SEC Release No. IC-29766 (August 31, 2011) (the "Concept Release"), we submitted a letter dated November 11, 2011 continuing to support the discussion and recommendations in the Task Force Report, including in respect of Section 18 issues.

[3] Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 48,525 (June 22, 1987) (stating, in the context of purchases and sales of, among other things, futures contracts, options on stock indexes and interest rate contracts, and forward contracts on currencies, "We agree that, if a fund meets the segregation requirements, a 'senior security' would not be present"), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf.

in order to comply with segregation requirements – even if based solely on mark-to-market value – the Fund will be required to reduce its exposure to derivatives.

As the Commission notes in the Proposing Release, market practice has evolved such that Funds segregate the entire notional amounts of certain derivatives and only the mark-to-market value of certain other types of derivatives.[4] In our Task Force Report, we suggested that the Commission clarify segregation requirements by requiring the segregation of "Risk-Adjusted Segregated Amounts," or "RASAs," and we appreciate that proposed Rule 18f-4 would implement a similar approach. Under the Commission's proposal, Funds would be required to segregate a transaction's mark-to-market value plus an additional risk-based coverage amount, defined in part as a reasonable estimate of the potential amount payable by the Fund if the Fund were to exit the derivatives transaction under "stressed conditions." In our view, assuming the Commission adopts this approach in its final rules, this enhancement will significantly strengthen the Commission's existing asset segregation regime, which will, in turn, make all the more clear that portfolio limitations of the types contained in the Proposing Release are not necessary for the Commission to meet its public policy objectives. However, we urge the Commission to provide further clarity on what conditions constitute "stressed conditions," such as "an estimate of three standard deviations of volatility." Otherwise, this term will be subject to wide interpretation by different industry participants.

The Proposed Portfolio Limitations Represent a Reversal of Longstanding Precedent and May Be Ineffective to Address Risks of Leverage

The Commission's proposed portfolio limitations appear to represent a reversal of almost 40 years of Commission and Staff precedent regarding senior securities and are based on notional amounts, which may have little relation to actual net risk. The proposed portfolio limitations would be based largely on notional amounts as a percentage of the value of a Fund's net assets. The notional amounts of some derivative instruments, however, have little to do with their actual risks, particularly when, as with the proposed 150% portfolio limitation, those amounts are calculated without taking into account the effects of offsetting exposures. As for the risk-based 300% portfolio limitation, we do not discern a basis in the 1940 Act for the Commission to set the limit at three times the net value of a Fund's assets rather than any other level. At the same time, because gross notional amounts have little inherent connection to net risk, the portfolio limitations may be largely ineffective to address the risks of leverage.[5]

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[4] Many Funds rely on informal guidance from the Staff that allows for the segregation of the net amount due on certain kinds of swaps and cash settled futures and forwards. That guidance has provided a welcome application of the principles underlying Release 10666 to certain instruments, including certain swaps and non-deliverable forward contracts, that the SEC and its staff had not previously addressed.

[5] We note our concern that, if market participants view the Commission's approach as being unreasonable and inconsistent with precedent, then they may characterize it as arbitrary and question the basis on which the Commission may seek to implement or enforce it.

As we stated above, the Commission's proposed portfolio limitations appear to lack a basis in the Commission's precedents regarding Section 18. Since at least 1979 and Release 10666, the Commission has taken the position that, to the extent a Fund "covers" its obligations in relation to transactions such as derivatives by segregating sufficient assets, there is no issue of compliance with Section 18. Nonetheless, the proposed rule posits that a Section 18 compliance issue may exist, even when a Fund segregates assets to the full extent required. Accordingly, the proposed rule would both require the "cover" long understood to eradicate the possibility of any Section 18 issue and limit the notional amounts of the derivative transactions in which a Fund may engage. This is a significant departure from the existing interpretive position that has served Funds and their shareholders well for almost 40 years. Given the absence of any problem or adverse impact resulting from existing industry practice and Staff positions, the portfolio limitations contained in proposed Rule 18f-4 seem both novel and unnecessary.

The Proposing Release makes clear that the Commission's analysis of the likely impact of the proposed rule is based in significant part on analysis conducted by the Commission's Division of Economic and Risk Analysis, including the so-called "DERA White Paper."[6] Based on that analysis, the Commission concludes, for example, that a great majority of Funds have aggregate derivatives exposures, measured by notional amounts, of less than 150% of the Funds' net assets – a finding of clear importance to the proposal. We appreciate the Commission's desire to understand the real-world effects of its rulemakings. Given the variety of concerns outlined above, and the serious questions raised about the data contained in the DERA White Paper underpinning the proposal, however, reliance on widely accepted empirical analysis will be critical to demonstrate reasonableness and soundness.

The Commission Should Consider an Alternative Approach, Under Which Funds Would Set Limits For Derivatives in Different Asset Classes Based on Their Risks

If the Commission ultimately determines to impose portfolio limitations, then we encourage the Commission to consider an alternative approach, under which Funds would determine notional-amount based portfolio limitations for derivatives in different asset classes in accordance with appropriate policies and procedures. Further, if the Commission determines to require portfolio limitations based on notional amounts, then, in our view, the definition of notional amounts should be refined to reflect in each case the effects of offsetting exposures and the netting and hedging of derivatives positions.

If the Commission determines that notional amount-based limitations are indeed necessary, such limitations should be based on the particular risks of derivatives asset classes as used by particular Funds. A Fund should determine the risks of different types of derivatives, as used by such Fund, and, based on appropriate policies and

[6] Daniel Deli, Paul Hanouna, Christof Stahel, Yue Tang & William Yost *Use of Derivatives by Registered Investment Companies* Division of Economic and Risk Analysis (2015), *available at* *http://www.sec.gov/dera/staffpapers/ white-papers/derivatives12-2015.pdf.*

procedures, should set notional amount-based limits for derivatives of different types. As with risk-based coverage amounts, Funds will presumably be best situated to evaluate and determine the appropriate portfolio limitations for each asset class based on a thorough assessment of their own particular facts and circumstances, and taking into account the way in which each Fund uses derivatives transactions and the terms and characteristics of its derivatives transactions.

We also understand that certain industry participants will offer comments that explore a variety of alternative percentage tests, and that the Commission will carefully assess those alternatives.

Scope of the Assets Eligible for Segregation Should be Significantly Expanded

Under the proposed rule, the "qualifying coverage assets" that a Fund may segregate to cover its obligations under derivatives positions are limited to cash, cash equivalents and the particular asset with which a Fund may satisfy its delivery obligation under a derivatives transaction. Accordingly, the Proposing Release would prevent Funds from segregating many of the types of assets that they have segregated in connection with their derivatives since 1996, when the Staff issued a no-action letter permitting Funds to segregate any asset, including equity securities and non-investment grade debt, so long as the asset is liquid and marked to market daily.[7]

That no-action letter significantly increased the degree to which Funds could use derivatives, because all or substantially all of their portfolio securities could be used to "cover" their derivatives positions. Contrariwise, the Commission's proposed Rule 18f–4 would significantly decrease the extent to which Funds would be able to use derivatives. We have previously noted our concern regarding restrictions on the types of assets that may be segregated to cover a Fund's performance of its obligations under its derivatives. In our Task Force Report, we expressed our view that the Commission should not limit the types of assets that may be segregated to only cash, U.S. Government securities and other high grade obligations because, for many Funds, holding more than a minimal amount of such securities would be inconsistent with their investment objectives and policies. For that reason, the limitations on qualifying coverage assets contained in proposed Rule 18f-4 would prevent some Funds from entering into derivative instruments that otherwise would be appropriate for them. Section 18 does not require this result, which is not in the interests of Funds or their shareholders. Rather, as we stated in the Task Force Report, the nature of the assets that a Fund may segregate to cover its obligations should be addressed in policies and procedures developed by a Fund's adviser, approved by the Fund's Board, and disclosed to potential Fund investors.[8]

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[7] Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996), *available at https://www.sec.gov/divisions/investment/imseniorsecurities/merrilllynch070196.pdf*.

[8] If, however, the Commission determines to materially limit Fund use of derivatives by severely limiting the types of assets that they may segregate, then we would encourage the Commission to coordinate the requirements of proposed Rule 18f–4 with the Commission's proposed rules requiring certain Funds to

We ask that the Commission revisit its proposal to limit the nature of qualifying coverage assets for derivatives. It is correct, of course, as the Proposing Release states, that assets other than cash and cash equivalents may decline in value in times of market stress, even if subject to haircuts. We submit, however, that accounting for potential falls in value is exactly the purpose of haircuts. In addition, under the Commission's proposal, Funds would be required to segregate not only the mark-to-market value of a derivative but also a risk-based coverage amount, the function of which is to over-segregate the amount of a Fund's current commitment under a derivative. Any such risk-based amount makes concerns over severe declines in market value due to market stress more remote.

The Commission appears to be of the view that, because margin provided for derivatives is often posted in the form of cash, coverage amounts, which are somewhat similar conceptually, should similarly be in cash. However, both the CFTC and the prudential banking regulators, in their final margin rules for uncleared swaps, permit margin to be provided by non-covered swap entities, such as Funds, in a far greater range of assets than those contemplated by the Commission in the Proposing Release.[9] We urge the Commission to maintain the practice of the past 20 years, which has worked well, under which a Fund may use any asset that is liquid and marked to market daily to cover its obligations in respect of derivatives. We note that, although the definition of qualifying coverage assets in relation to financial commitment transactions is broader than that for derivatives positions, our comments here apply with equal force to the definition of qualifying coverage assets for financial commitment transactions.

The Proposed Rule's Definition of "Financial Commitment Transaction" Is Overly Broad and Should Be Modified to Exclude Certain Contingent Obligations

The scope of the proposed rule's exemption permitting Funds to enter into derivatives transactions and financial commitment transactions, and the proposed rule's related requirements, are tied to the definition of "financial commitment transaction" which is: *any reverse repurchase agreement, short sale borrowing, firm or standby commitment agreement or similar agreement*.[10] For this purpose, the proposed rule identifies a "similar agreement" as any "agreement under which a fund has obligated itself, conditionally or unconditionally, to make a loan to a company or

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adopt and implement liquidity risk management programs. It would be helpful, we believe, for both rulemakings, when finalized, to share a common definition of what constitutes a liquid instrument.

[9] See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636, 701-702 (Jan. 6, 2016); Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74839, 74903-04 (Nov. 30, 2015) (both permitting financial end users to post as initial and variation margin, among other things, cash in numerous currencies, obligations of the U.S. Treasury Department and certain foreign sovereigns, certain securities that are issued by, or unconditionally guaranteed by, U.S. government agencies, certain publicly-traded debt, and publicly traded common equity securities included in the Standard & Poor's Composite 1500 Index).

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

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."[11] The proposed rule would require a Fund that chooses to enter into a financial commitment transaction in reliance on the proposed exemption to simultaneously set aside and maintain "qualifying coverage assets" equal in value to the full amount that the Fund is conditionally or unconditionally obligated to pay under the terms of such transaction.[12] A Fund's use of financial commitment transactions in reliance on the exemption would also be subject to a portfolio-level limit, and various other requirements. Moreover, a Fund's Board would be required to adopt and oversee policies and procedures governing that Fund's use of financial commitment transactions in reliance on the proposed rule, including specific policies "reasonably designed to provide for the fund's maintenance of qualifying coverage assets."

We are concerned that the proposed definition of "financial commitment transaction" is overly broad and may include transactions that do not raise any of the concerns the proposed rule is intended to address. In particular, the proposed rule's definition of financial commitment transactions includes *conditional* obligations to make a loan or equity investment even if the condition is entirely within the control of the Fund. Moreover, by including such conditional obligations within the exemption from Section 18, the proposed rule implies that these conditional obligations represent senior securities.

We understand that the Commission's intention in including conditional obligations of a Fund, as described in the Proposing Release, was to capture contingent liabilities such as standby commitment letters, pursuant to which a Fund's obligation, though conditional, can materialize upon the occurrence of conditions beyond the control of the Fund providing the financial commitment. But without any express limitation, the proposed rule could be interpreted as meaning that a "financial commitment transaction" includes an agreement with conditional obligations where the satisfaction of the condition, or the determination of whether a condition has been satisfied, is within the sole control, or at the sole discretion of, the Fund. Consider a Fund which enters into an agreement obligating the Fund to loan money at a future date, conditional on the borrower's business prospects evidencing an ability to repay the loan, the determination of which rests exclusively with the Fund and in its sole discretion. In this example, determining the existence of an event which triggers a Fund's liability is entirely within the control of the Fund, and is a categorically different from the obligations under a standby commitment letter or other instrument which turns on a condition *outside* the control of the Fund.

Moreover, the proposed definition as drafted may inadvertently capture non-binding term sheets or other preliminary transaction documents that create an "agreement to agree." Since such agreements typically include a promise to lend or purchase upon the occurrence of certain conditions, including the execution of a

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[11] *Id.*

[12] Proposed Rule 18f-4(b)(1).

binding agreement incorporating the terms of the term sheet, in the absence of any express limitation in the rule, an "agreement to agree" could be classified as a "financial commitment transaction" triggering the rule's requirements. Since such speculative agreements do not impose a contingent obligation which may occur *without the future agreement* of the parties, they are fundamentally different than the types of financial commitment transaction discussed in the Proposing Release, and do not create the risks the proposed rule is designed to guard against.

For the foregoing reasons, we request that the Commission clarify in the text of a final rule, if adopted, that financial commitment transactions subject to the requirements of the proposed rule will not include contingent obligations which are subject to conditions the satisfaction of which is within the sole control of the Fund. In addition, we request that the Commission clarify in any adopting release that non-binding term sheets or other prospective "agreements to agree" will not generally be considered subject to the limitations of Section 18 of the Act or subject to the proposed rule's requirements for financial commitment transactions.

The Proposed Rule Would Unduly Interfere with the Intended Function of BDCs

In addition, we are concerned that by failing to differentiate between BDCs and other types of registered investment companies, the proposed rule would unduly interfere with the intended function of BDCs as a source of capital for small and medium-sized U.S. businesses. In enacting Section 61 of the 1940 Act, Congress intentionally provided BDCs with the ability to incur leverage beyond that permitted to other types of registered funds. In particular, BDCs are subject to a 200% asset coverage requirement for any senior securities, as opposed to the 300% asset coverage requirement applicable to closed-end funds' senior securities representing indebtedness and the prohibition limiting open-end funds from issuing any Section 18 senior securities (except for limited bank borrowings) whatsoever. In creating BDCs, Congress recognized the critical importance of small businesses to the American economic system in terms of innovation, productivity, increased competition and job creation, and intended to incentivize the provision of capital to such businesses by removing unnecessary and burdensome regulatory obstacles.[13]

Unlike other types of registered funds, which typically invest in a broad range of relatively liquid securities (and are subject to a 15% limit on investments in illiquid securities under both longstanding commission guidance and proposed Rule 22e-4), BDCs are required to make most of their investments in the form of loans to small and medium-sized American businesses. Permitting BDCs to incur more debt than other registered funds provides a BDC with easier access to capital, reducing the chance that it will be forced to decline credit to a potential borrower due to a lack of cash,

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[13] *See generally* House of Representatives Report, Interstate and Foreign Commerce Committee, 96-1341, H.R. Rep. No. 1341, 96th Cong., 2nd Sess. (Noting that the bill addresses a recent "slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses" which are of primary importance to the "American economic system in terms of innovation, productivity, increased competition and the jobs they create…").

and serving the statutory goal of increasing capital access to small businesses. In addition, because a significant portion of a BDC's assets will typically consist of relatively illiquid small business loans at any given time, it must rely on debt as a source of readily-available capital to a greater extent than other types of funds, which typically have a greater ability to raise cash by selling portions of their liquid holdings.

The proposed rule would end the thirty-five year old policy that now permits BDCs greater access to leverage than other types of funds, undermining clear congressional intent. First, BDCs that choose to rely on the exemption from Section 18 in the proposed rule would be subject to the same restrictions as other registered funds with respect to their use of derivatives and reverse repurchase agreements as a potential tool for creating liquidity. While BDCs have not historically used such instruments to the same extent as other types of funds, as financial markets continue to evolve, such instruments may become a more attractive source of short-term financing to BDCs. BDCs should have a greater ability to engage in such transactions than other types of funds, consistent with Sections 18 and 61.

Second, and of more immediate concern, the definition of "financial commitment transaction" in the proposed rule would encompass a BDC's unfunded commitments to make loans. Because a BDC effectively acts as a lender, such unfunded commitments (such as commitments to make term loans) are a necessary aspect of its business, and are likely to represent a significant portion of its liabilities at any given time. The proposed rule would require a BDC to set aside qualifying coverage assets to cover the expected amount of such commitment, and would cap the amount of such obligations at 100% of net assets.

Requiring BDCs to set aside a dollar of liquid assets for every dollar of unfunded credit commitments runs contrary to congressional intent. Not only would this reduce the supply of capital to small and medium-sized businesses in contravention of statutory policy, but it also fails to differentiate between unfunded credit commitments, on the one hand, and other types of "financial commitment transactions" utilized by non-BDC funds, such as short sale borrowings and repurchase agreements, that carry far greater risks, on the other. Unlike borrowing undertaken to effect short sales, for instance, an unfunded commitment to extend credit does not expose a BDC to the risk of unlimited losses. Furthermore, a BDC's purpose for entering into an unfunded commitment is not to benefit from the change in price on an underlying security, with the hope of achieving an "in-the-money" outcome; on the contrary, BDCs generally intend to fund their commitments and, in turn, generate profits from making loans to small and medium-sized American businesses as intended by Congress. In this way, unfunded commitments as utilized by many BDCs do not reflect the concerns raised by Congress in the 1940 Act or those raised by the Commission in the Proposing Release (or previously in Release 10666).[14]

[14] The SEC has regularly taken the position in comment letters regarding BDC filings that unfunded commitments are "senior securities" subject to the asset coverage requirements of Section 61. Many BDCs have replied to SEC comments arguing that unfunded commitments should not be treated as

The Proposing Release notes that the proposed rule would not restrict the ability of a BDC to continue to engage in leveraging transactions pursuant to Section 61, without relying on the proposed rule. However, applying the proposed rule's logic, even if a BDC elects not to rely on the proposed rule's exemption, it would still be deemed to have "senior securities indebtedness" under Section 61 in the amount of its unfunded commitments. As a result, a BDC's unfunded commitments could use up some or all of the BDC's capacity to incur leverage under Section 61's 200% asset coverage test, preventing the BDC from using such capacity for its intended purpose: as a means of generating cash to fund investments in small and medium-sized American businesses.

Accordingly, we respectfully suggest that any final rule, and adopting release, be revised to give fuller effect to congressional intent regarding BDCs. BDCs should have greater flexibility to engage in derivatives and financial commitment transactions under Rule 18f-4 than other types of funds. This could be accomplished by increasing the cap on qualifying coverage assets under the proposed rules' exemption for BDCs beyond 100%, or by reducing the asset coverage requirements applicable to derivative and financial commitment transactions for a BDC. In addition, unfunded commitments by a BDC to invest in eligible assets (such as small business loans) should not be included in the definition of "financial commitment transaction", and the adopting release should clarify that such commitments do not constitute "senior securities indebtedness" for purposes of Section 61.

The New Tasks for Directors Contained in the Proposed Rule May Unduly Extend the Board's Role into Risk Management and Should be Reconsidered and Clarified

Proposed Rule 18f-4 contemplates additional, new tasks for directors, including the approval of extremely detailed policies and procedures that must address numerous specified items, some of which are highly technical in nature. Among other things, directors of funds that, under the proposed rule, would be required to have a derivatives risk management program, would be required to:

- Approve such derivatives risk management program ("Program") and any material changes to the Program;
- Approve procedures effecting the Program, which must be reasonably designed to assess the risks of the Fund's derivatives transactions (including potential leverage, market, counterparty, liquidity, operational and other risks considered relevant);
- Approve one of two alternative portfolio limitations;

senior securities, but typically also agreeing to make the additional disclosures or representations requested by the SEC. *See, e.g.,* "Comment Letter of Horizon Technology Financial Corporation," June 17, 2015 *available at* https://www.sec.gov/Archives/edgar/data/1487428/000114420415037700/0001144204-15-037700-index.htm and "Comment Letter of Prospect Capital Corporation," October 9, 2015 *available at* https://www.sec.gov/Archives/edgar/data/1287032/000128703215000287/filename7.htm

- Approve asset segregation policies and procedures, which must provide for segregation of both a mark-to-market coverage amount and a risk-based coverage amount; and

- Designate a derivatives risk manager (and review quarterly reports that describe the adequacy of the Program and the effectiveness of its implementation).

Consistent with our comments on the Commission's proposed Rule 22e-4 under the 1940 Act, the Committee urges the Commission to carefully consider the role of a Fund's Board in connection with proposed Rule 18f-4 and whether it is appropriate to involve the Board so deeply in areas where, despite their general oversight responsibility, they must as a practical matter reasonably rely on the expertise of the Fund's investment adviser or third-party consultants. While a Board is responsible for overseeing the identification and mitigation of risks, we are concerned that imposing specific, new responsibilities on Boards of the type required by proposed Rule 18f-4 may go a step beyond the traditional Board role into areas that are properly the province of the investment adviser. For example, absent clarifying guidance to directors in the adopting release for the final rule, directors may be concerned that they are required to develop an in-depth understanding of the technicalities of value-at-risk models or the computation of the risk-based-coverage amount for complex derivatives before approving a Program recommended by a fund's adviser, which would be inconsistent with their oversight role, and a practical impossibility for many independent fund directors. The Committee believes that the Commission should clarify that the Board's role related to derivatives risk management generally is consistent with its general oversight role and with its role under Rule 38a-1, which mandates that Funds adopt written compliance policies and procedures reasonably designed to ensure compliance with the final rule, and that such compliance policies and procedures be subject to Board approval.

The Committee remains concerned that the Commission is seeking to move the traditional role of the Fund Board from oversight, and in particular, oversight of potential conflicts of interest, closer to an investment management role. In the Proposing Release, the Commission does not clearly articulate why Boards should take on these new responsibilities, where the actual conflicts lie, or what value they can add to the work of the investment adviser. Consistent with our prior comments on proposed Rule 22e-2, the Committee urges the Commission to confirm in any adopting release for Rule 18f-4 that nothing in the final rule or the adopting release changes the relevant legal standard in respect of Board oversight of Funds and their investment advisers.

Assuming the Commission Determines to Make Material Changes to the Proposed Rule, or the Comment Process Develops Important New Information or Alternative Proposals, then the Commission Should Re-propose the Rule

We understand that this is only one of many comment letters that the Commission will receive regarding the Proposing Release. We note that the proposed rule could have wide-reaching effects on particular Funds and their strategies that already have passed through the Commission's registration and/or exemptive process, and that requiring those Funds to substantially change their investment strategies or liquidate or de-register as investment companies is a significant consequence for those Funds and their shareholders.

The proposed rule could also have wide-reaching effects on the industry's ability to continue to innovate to meet the needs and objectives of Fund investors in increasingly challenging and complex global financial markets. Within this context, we understand that industry participants may have serious questions about the analysis contained in the Proposing Release and will offer comments that explore measures of risk other than notional amounts, as well as a variety of alternative percentage tests. If, notwithstanding our views on the sufficiency of asset segregation, the Commission believes that portfolio limitations tests are indeed required, then, given the importance of this issue to the industry, the significant reversal of precedent that the Commission proposes, and the variety of comments we expect, we encourage a careful and thorough reassessment.

In our view, an appropriate reassessment should include a fresh review of other approaches within the existing framework, consideration of the alternative percentage tests that we expect to be presented, and a recognition of the likelihood that the Commission and industry participants will benefit from a further debate that is only possible once the full range of comments and alternatives are in the public record. We believe such a debate requires a re-proposal and a further period for public comment. We encourage the Commission to follow that approach, again, assuming the Commission continues to believe, with the benefit of public comments, that a reversal of precedent and departure from a segregation-based approach is necessary.

In addition, we note that the Proposing Release does not address a number of the issues raised in the Concept Release, including those relating to diversification requirements, exposure to securities-related issuers, and concentration limitations. We respectfully urge the Commission to address these and other issues identified in the Concept Release, and again refer to our prior suggestions in the Task Force Report, which were reiterated in our November 11, 2011 letter on the Concept Release.

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We appreciate the opportunity to comment on the Proposing Release and proposed Rule 18f–4, and respectfully request that the Commission consider our recommendations and suggestions. We are available to meet and discuss these matters with the Commission and its Staff, and to respond to any questions.

Very truly yours,

David M. Lynn
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