TPG SPECIALTY LENDING

April 2, 2020

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Release No. 34-87607; IA-5413; IC-33704; File No. S7-24-15
Use of Derivatives by Registered Investment Companies and Business Development Companies

Dear Ms. Countryman:

On March 29, 2020, TPG Specialty Lending, Inc. submitted comments in response to the request of the Securities and Exchange Commission in connection with the above-captioned release re-proposing Rule 18f-4 (such rule, as proposed, "Rule 18f-4") under the Investment Company Act of 1940, as amended.

As a supplement to that letter, we attach as Exhibit A hereto a presentation to further illustrate our view of the importance of our proposed modifications to the definition of limited derivatives users in Rule 18f-4 to facilitate the use of interest rate swaps by business development companies as a risk management tool.

We would be pleased to respond to any inquiries you may have regarding our prior letter, this presentation or our views on Rule 18f-4 more generally. Please feel free to direct any inquiries to Mr. Joshua Easterly at .

Very truly yours,

Joshua Easterly
Chairman and Chief Executive Officer
TPG Specialty Lending, Inc.

# **Exhibit A**

# Preserving An Important Risk Management Tool for the BDC Sector

## Response to SEC Request for Comments on Proposed Rule 18f-4
## Use of Derivatives by BDCs

April 2020

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# Proposed Rule 18f-4

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## "Limited Derivatives User" Exception

- The SEC has requested comments relating to proposed Rule 18f-4 that would regulate the use of derivatives by funds, including BDCs.
- In proposing the rule, the SEC acknowledges that certain types of derivative transactions used by funds to hedge single risks related to specific investments do not raise investor protection concerns underlying Section 18 of the '40 Act.
- The rule includes an exception from certain aspects of the proposed rule for "limited derivatives users," which are funds that either:
    1. Limit their use of derivatives to currency derivatives used solely to hedge currency risks associated with specific foreign-currency denominated investments ("the hedging exception"); or
    2. Limit their notional exposure to derivatives to 10% of net assets ("the exposure exception").
- A fund that qualifies as a "limited derivatives user" would avoid incremental compliance and cost burdens of the full derivatives management program required by Rule 18f-4.

# Proposed Rule 18f-4 (continued)

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## "Limited Derivatives User" Exception – BDC Sector

- **To avoid creating an unintended disincentive for the BDC sector** to utilize risk management tools, we believe the scope of "limited derivatives users" definition should be broadened.
- Specifically, we suggest the following changes to the two-prong "limited derivatives user" exception:
    1. Expand "hedging exception" to cover interest rate derivatives, such as interest rate swaps used solely to hedge interest rate exposure on investments, in addition to currency derivatives.
    2. Expand "hedging exception" to cover derivatives related to fund's borrowings, in addition to investments.
    3. Exclude hedging derivatives from calculation of notional exposure for "exposure exception."
- With predominantly floating rate asset exposure and no existing investor market for floating rate notes market for BDCs, BDCs' primary options for unsecured debt funding are fixed rate securities (i.e., investment grade bonds and convertible notes).
- Interest rate swaps with notional amounts equivalent to the par value of fixed-rate investments and the principal amount of fixed rate borrowings facilitate matching of asset-liability exposures. However, the proposed rule creates an artificial barrier against the practical application of this risk management tool for BDCs.

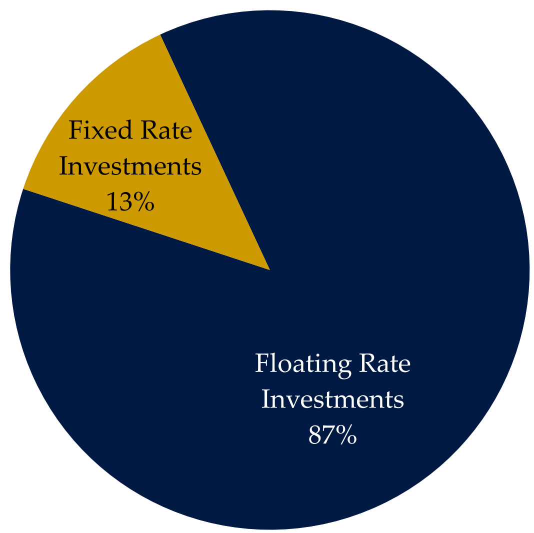
# Asset and Liability Composition of the BDC Sector

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

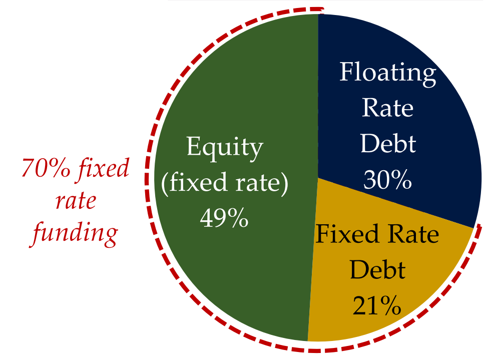
3 Our Proposed Amendment

## Average BDC Portfolio Composition

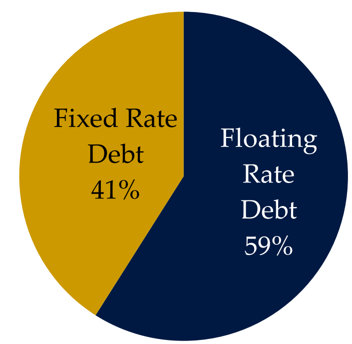



## Average BDC Funding Composition[1]

OVERALL FUNDING




DEBT LIABILITY FUNDING




*(1) Excludes the impact of interest rates swaps for TSLX and ORCC.*
*(2) BDCs are subject to distribution requirements.*
*Source: KBW Research (based on their BDC coverage universe of AINV, ARCC, BBDC, BCSF, CGBD, CPTA, FDUS, FSK GBDC, HCAP, HRZN, HTGC, NMFC, OCSL, ORCC, PFLT, PNNT, PTMN, SCM, SLRC, TCPC, TCRD, TPVG, TSLX), based on 12/31/2019 balance sheet.*

- The BDC sector has predominantly floating rate assets and a mix of fixed and floating debt liabilities.
- Given its mostly fixed capital funding base (i.e. fixed rate debt and equity capital), the BDC sector is favorably positioned for rising rates but unfavorably positioned for falling rate environments.

# Debt Funding Sources for the BDC Sector

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## Floating Rate Debt Funding Options for BDCs

**Revolving Credit Facilities**
- *Secured*
- *Governed by borrowing base calculations referencing fair values*
- *3-5 year tenor*
- *More restrictive financial covenants*

**Collateralized Loan Obligation (CLO) / Special Purpose Vehicle (SPV)**
- *Secured*
- *SPVs may have mark-to-market requirements / subject to margin calls*
- *3-5 year tenor*
- *More restrictive financial covenants / requirements*

**Floating Rate Notes**
- *Unsecured; no borrowing base*
- *5 year tenor*
- *Less restrictive financial covenants*

*No existing market for BDCs*

## Fixed Rate Debt Funding Options for BDCs

**Investment Grade Bonds**
- *Unsecured; no borrowing base*
- *5-30 year tenor*
- *Less restrictive financial covenants*

**Convertible Debt**
- *Unsecured; no borrowing base*
- *5-7 year tenor*
- *Less restrictive financial covenants*
- *Value of conversion option may lower fixed coupon rate*

**Small Business Investment Company Debt (SBIC)**
- *Unsecured; no borrowing base*
- *10-year tenor*
- *Does not count against statutory asset coverage requirements*
- *Requires license from the SBA and incremental administrative obligations*

- Floating rate notes are an ideal debt funding option for BDCs due to its flexibility (i.e. unsecured, no mark-to-market) and the ability to match-fund accordingly with the floating rate nature of BDC portfolios. However, **there is no investor market for floating rate notes for BDCs.**
- The most efficient way to replicate floating rate notes is to issue fixed rate investment grade bonds and implement fixed-to-floating interest rate swaps on the principal amount of the bonds.

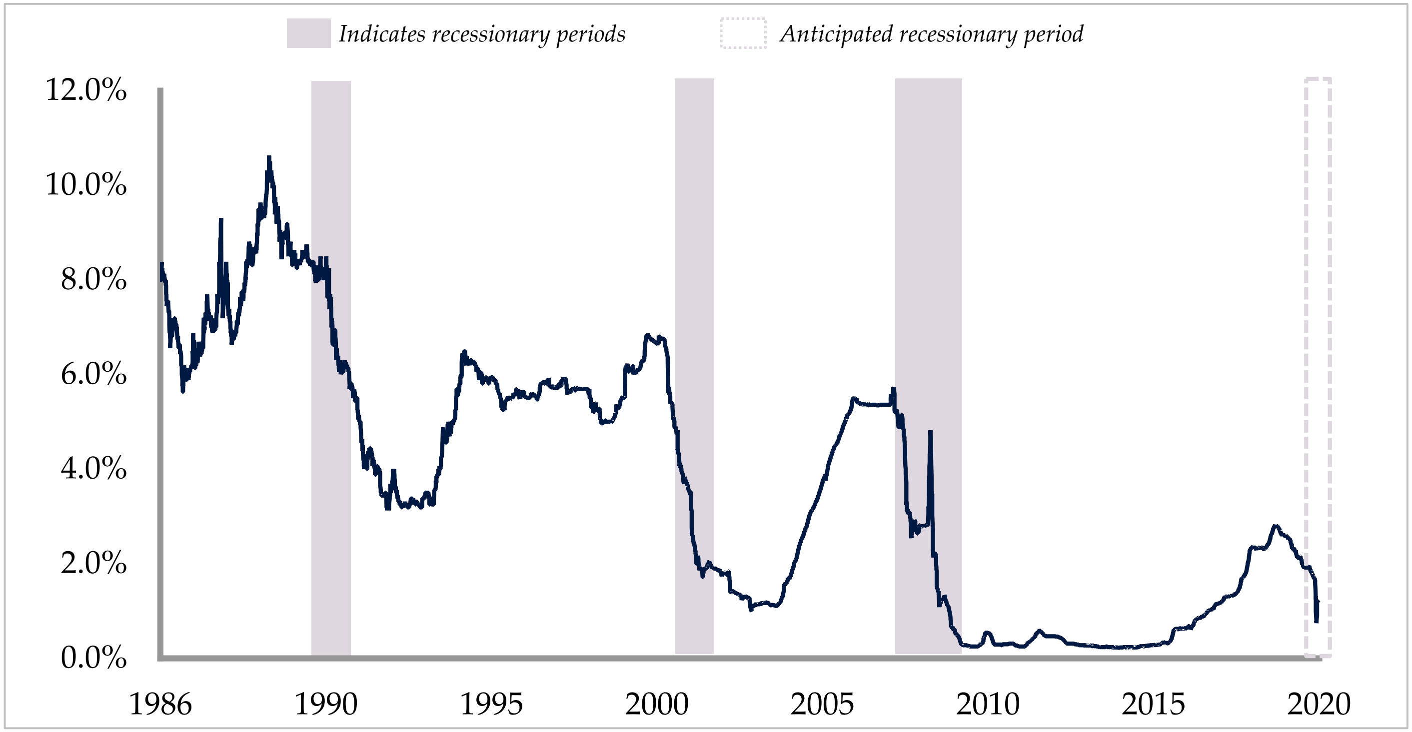
# Interest Rate Environment and Economic Cycles

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## Historical 3-Month LIBOR and Economic Cycles




*Source: www.macrotrends.net/2520/3-month-libor-rate-historical-chart*

- Historically, declining interest rate environments have been correlated with recessionary periods.
- For spread-lenders like BDCs, having unhedged fixed rate debt during these periods would result in net interest margin contraction.
- Therefore, the use of interest rate swaps to manage this financial exposure offers important downside protection to the sector's stakeholders, which we believe is especially relevant in today's environment.

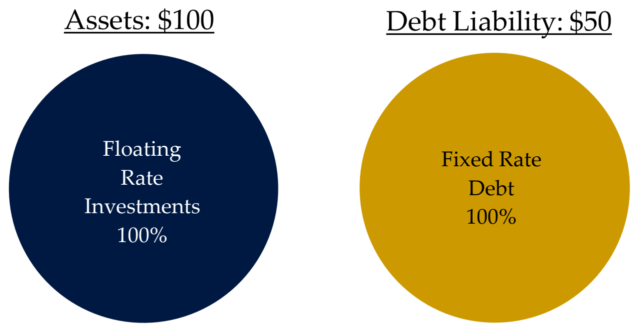
# Interest Rate Sensitivity of the BDC Sector

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## Illustrative Example



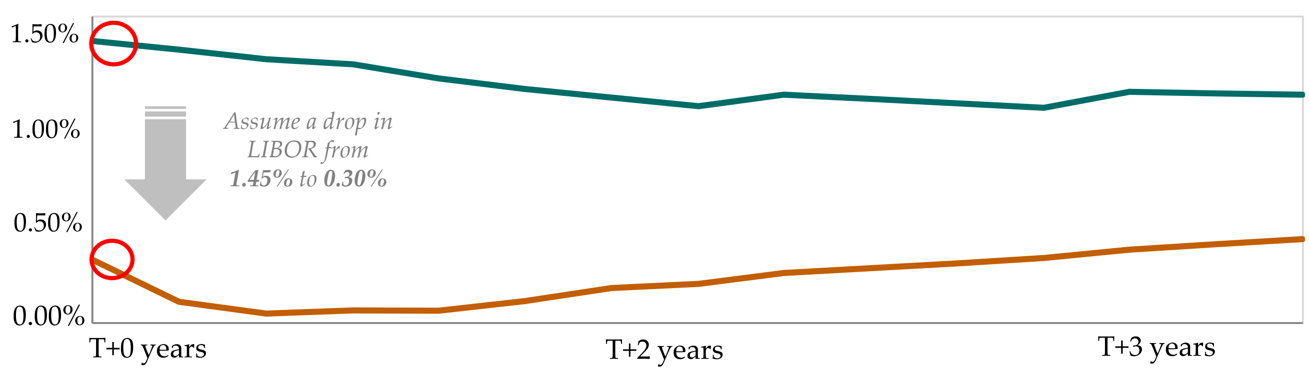

**BDC XYZ**

***Assumptions***

- Average spread on assets: L+700, no LIBOR floor
- Coupon on fixed rate debt: 4.0%
- 3-month LIBOR (spot): 1.45%

## Decline In Interest Rate Environment

ILLUSTRATIVE 3-MONTH LIBOR FORWARD CURVE




In this scenario where there is a decline in the interest rates, the downward impact to BDC XYZ's net interest margin would vary significantly depending on its risk management approach / hedging activity.

# Interest Rate Sensitivity of the BDC Sector (continued)

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## Net Interest Margin Impact (Decline in spot LIBOR from 1.45% to 0.30%)

***BDC XYZ Assumptions***

- Assets: $100
- Fixed rate debt: $50
- Average spread on assets: L+700, no LIBOR floor
- Coupon on fixed rate debt: 4.0%

### BDC XYZ (NO INTEREST RATE HEDGING)

*Assumes BDC XYZ pays a 4.0% coupon on its fixed rate debt.*

| Net Interest Margin (1.45% LIBOR) | |
|---|---|
| Interest income | $8.5 |
| Interest expense | ($2.0) |
| Net interest margin | $6.5 |

| Net Interest Margin (0.30% LIBOR) | |
|---|---|
| Interest income | $7.3 |
| Interest expense | ($2.0) |
| Net interest margin | $5.3 |

| | |
|---|---|
| *% change in net interest margin* | *-17.8%* |

### BDC XYZ (WITH INTEREST RATE HEDGING)

*Assumes BDC XYZ had previously entered into an interest rate swap on its fixed rate debt so that it pays L+2.55% and receives 4.0%.*

| Net Interest Margin (1.45% LIBOR) | |
|---|---|
| Interest income | $8.5 |
| Interest expense - hedged(1) | ($2.0) |
| Net interest margin | $6.5 |

| Net Interest Margin (0.30% LIBOR) | |
|---|---|
| Interest income | $7.3 |
| Interest expense - hedged(1) | ($1.4) |
| Net interest margin | $5.9 |

| | |
|---|---|
| *% change in net interest margin* | *-8.9%* |

*(1) Interest expense on debt is calculated as $50 * (applicable LIBOR + 2.55%).*

BDC XYZ's interest rate sensitivity is mitigated through the use of interest rate swaps, resulting in less downward impact on net interest margin in a declining interest rate environment.

# Considerations for Proposed Rule 18f-4

1 Background

2 Practical Implication of a Narrow "Limited Derivative Users" Exemption

3 Our Proposed Amendment

## Our Proposed Amendment

We have proposed the following changes (blacklined below) to the definition "limited derivatives users" to Rule 18f-4(c)(3):

> (3) *Limited derivatives users*. A fund is not required to adopt a program as prescribed in paragraph (c)(1) of this section, or comply with the limit on fund leverage risk in paragraph (c)(2) of this section, if the fund adopts and implements policies and procedures reasonably designed to manage the fund's derivatives risks and~~: (i) The~~ the fund's derivatives exposure does not exceed 10 percent of the fund's net assets~~; or (ii) The fund limits its use of~~ (excluding, for this purpose, derivatives ~~transactions to currency~~ exposure related to derivatives that hedge the currency or interest rate risks associated with (A) specific ~~foreign currency- denominated~~ equity or fixed- income investments held by the fund, or (B) senior securities issued by the fund, provided that ~~the currency~~such derivatives are entered into and maintained by the fund for hedging purposes and that the notional amounts of such derivatives do not exceed the value of the hedged instruments denominated in the foreign currency (or the par value thereof, in the case of fixed-income investments) by more than a negligible amount).

We believe our recommendations to the definition of "limited derivatives users" are:

- ☑ Consistent with the SEC's objective of providing a principles-based approach to measuring derivatives exposure in an efficient and effective way; and
- ☑ Will more fully capture funds that use only the types of derivatives that the staff agrees do not implicate the policy concerns underlying the proposed rule.

# Considerations for Proposed Rule 18f-4

## Benefits of our recommendations to the "limited derivatives users" definition

- ✓ Includes similar types of derivatives to currency hedges, notably interest rate swap arrangements, that are used by funds for risk management rather than investment purposes.

- ✓ Eliminates the disincentive (i.e. incremental costs and compliance obligations) for funds to use derivatives in a limited and clearly articulated way to hedge interest rate risk tied to specific investments or to the fund's borrowings.

- ✓ Consistent with the SEC's objective of providing investor protection in a principles-based approach to measuring derivatives exposure in an efficient and effective way.

**<u>Avoids creating a disincentive</u> to use an important risk management tool for the benefit of the sector's stakeholders**

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