Submitted Electronically

March 28, 2016

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

Re: Proposed Derivatives Rules (File No. S7-24-15)

Dear Mr. Fields:

The Private Equity Growth Capital Council (the "PEGCC") respectfully submits this comment letter in response to a proposal by the Securities and Exchange Commission (the "SEC") to adopt a rule under the Investment Company Act of 1940 (the "Investment Company Act") that would address the use of derivatives and certain forms of leverage by registered investment companies ("RICs") and business development companies (the "Proposed Rule").[1]

As discussed further below, the PEGCC respectfully submits that including unfunded capital commitments within the definition of "senior security" under Section 18 of the Investment Company Act is not supported by the statute or the purposes underlying the statute and the risks associated with meeting unfunded capital commitments are appropriately addressed elsewhere in the Investment Company Act. If the SEC elects to characterize unfunded capital commitments as senior securities, however, then the SEC should at least provide greater flexibility with respect to the asset segregation requirement that would be imposed by the Proposed Rule.

The PEGCC is an advocacy, communications and research organization established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007, and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The PEGCC members are the world's leading private equity and growth capital firms, united by their commitment to growing and strengthening the businesses in which they invest. In addition, certain PEGCC members also manage RICs that invest in private funds and thus would be directly impacted by the Proposed Rule.

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[1] Use of Derivatives by Registered Investment Companies and Business Development Companies, SEC Release No. IC-31933; File No. S7-24-15, 17 CFR 270.18F-4 (Dec. 11, 2015) (the "Proposing Release"), available at https://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

I. Summary

Although the Proposed Rule does not apply directly to private funds, PEGCC members would be affected by the Proposed Rule because RICs may find otherwise desirable investments in private equity funds to be less attractive because of the burdens of the asset segregation requirements discussed below. This would inhibit the ability of our members to raise capital and hinder the ability of RICs to invest in private funds that are consistent with their investment objectives.

Our comments focus on the requirements that the Proposed Rule would impose on RICs that seek to invest in private funds and, as a result, may enter into the type of arrangement that the SEC has, we believe, mistakenly categorized as a "financial commitment transaction." The Proposed Rule would treat a commitment to invest in a private fund as a "financial commitment transaction" and require the RIC to maintain qualifying coverage assets equal to the value of its future commitment. Among other things, the Proposed Rule would establish new requirements with respect to "financial commitment transactions." The PEGCC respectfully submits that:

- The types of unfunded capital commitments that characterize investments in private funds are not "senior securities" within the meaning of Section 18 of the Investment Company Act;

- Section 18 was designed to limit the use of leverage by RICs; unfunded capital commitments do not create leverage and entering into such commitments is not an evasion of the statute;

- The need to meet future private fund commitments is an issue of liquidity management and not leverage, and can be addressed through other means;

- If the SEC elects to treat unfunded capital commitments as senior securities, however, the Final Rule should at a minimum provide RICs with significantly more flexibility in determining the amount and type of assets that would be required to meet the segregation requirements; and

- The SEC should give further consideration to the impact that the Proposed Rule would have on existing RICs. We believe that the Proposed Rule could cause certain RICs (particularly funds of private funds) to significantly alter their strategies (and thus, fail to meet the expectations of their shareholders) or force them to deregister as RICs. The SEC should also "grandfather" existing capital commitments and provide existing RICs with a significant transition period (not less than five years) to adapt to the Final Rule or find a means to meet the expectations of their shareholders.

II. Background: The Nature of Interests in Private Equity Funds

Private equity funds are pools of capital formed to make privately negotiated investments in various types of businesses. A private equity fund is generally organized as a limited partnership and issues limited partnership interests to investors. The limited partner commits to invest a specified amount of capital in the private equity fund. However, unlike many issuers, the limited partner is generally not required to provide all of the capital it has committed at once. Rather, the amount of capital committed to the private equity fund is generally drawn down as and when needed as underlying investments are identified by the private equity fund's general partner or sponsor. This approach benefits both the private equity fund sponsor (who does not have to manage capital funds before investments that meet the fund's investment objectives become available) and private fund investors who provide the capital only when necessary.

Most private equity funds have a fixed life (generally ten years, subject to extensions) and typically have a shorter "investment period" (often five to six years) during which the general partner may call capital to make investments. Once the investment period has expired, capital may no longer be called, subject to limited exceptions. It is important to keep this structure in mind in evaluating whether it is appropriate to treat capital commitments to private funds as financial commitment transactions. It is simply not clear, before the end of the investment period, when the capital commitment will be called or even whether the full amount of the capital commitment will be called.

The Proposed Rule defines the term "financial commitment transaction" to include "any firm or standby commitment agreement or similar agreement (such as an agreement under which a fund has obligated itself, conditionally or unconditionally, 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)." The PEGCC respectfully submits that this definition goes far beyond the definition of "senior security" in Section 18 of the Investment Company Act and the SEC's prior guidance on the scope of Section 18.

III. Unfunded Capital Commitments Are Not Senior Securities

Section 18 of the Investment Company Act prohibits or limits the ability of RICs to issue "senior securities." Section 18 defines a senior security, in pertinent part, as "any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness." As an initial matter, the PEGCC does not believe that the language or the underlying purpose of Section 18, or the SEC's guidance concerning the scope of the definition of "senior security," supports the SEC's view that financial commitments to private funds are senior securities.

A. Statutory Language and Purpose of Section 18

The SEC bases its conclusion that financial commitments are "senior securities" on the fact that they can be viewed as an obligation similar to a "bond, debenture or note" constituting "evidence of indebtedness."[2] We note that the plain language of the definition of "senior security" requires that it be a "security" and that the term only covers obligations or instruments "constituting a security."[3] As the SEC acknowledges, these types of financial commitments are not treated as "securities" for any other purpose under the federal securities laws or even the Investment Company Act.[4] The language of Section 18 does not indicate that the definition of "security" in Section 18 was intended to be different from the rest of the Investment Company Act, since it does not separately define "security." Thus Section 18 incorporates the definition as used generally in the Investment Company Act.

We appreciate that the SEC may have concerns for arrangements (whether or not characterized as securities) that are designed to evade the limitations imposed by Section 18. However, uncalled capital commitments do not fall within these concerns.[5] Section 18 was designed to limit the extent to which RICs could have leveraged capital structures.[6] As discussed in greater detail below, a commitment to invest in a private fund simply does not create leverage, which Section 18 was designed to address.

The SEC suggests that Section 18 was also intended to address the risks of "funds operating without adequate assets and reserves" and cites Section 1(b)(8) of the Investment Company Act. We appreciate the SEC's concerns in this regard, but we believe that adopting a rule under Section 18 to address this concern is a blunt instrument at best. This concern can be addressed by SEC or staff guidance emphasizing the importance of a RIC having sufficient liquid assets (or credit lines) to meet its obligations.[7] In the absence of any evidence that Section 18 was intended to address

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2 *See* Proposing Release at 16.

3 Section 18(g) provides that a senior security is "any bond, debenture, note, or similar obligation or instrument *constituting a security* and evidencing indebtedness" (emphasis added).

4 *See* Proposing Release at 16.

5 We discuss the issues raised by the SEC's guidance concerning certain of these trading practices below. We note that unfunded capital commitments simply do not present those issues.

6 *See* Section 1(b)(7) of the Investment Company Act ("when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities").

7 As discussed below, the SEC has proposed a rule applicable to open-end RICs that would take that approach. We do not believe that it is necessary to extend that rule to closed-end RICs, but the SEC may conclude that guidance on this issue may be appropriate.

liquidity concerns independent of leverage, we do not believe that there is any justification to interpret “senior security” under Section 18 as capturing transactions that do not create leverage.

B. Release 10666

In 1979, the SEC issued guidance (Release 10666) that addressed the use of certain trading practices by RICs that the SEC believed raised concerns that Section 18 was designed to address.[8] Release 10666 was tailored to address certain types of practices (specifically, reverse repurchase agreements, repurchase agreements, firm commitment agreements and standby commitment agreements) that the SEC concluded, while not securities for all purposes under the federal securities laws, “fall within the functional meaning of the term ‘evidence of indebtedness’ for purposes of section 18 of the [Investment Company] Act.”[9]

The SEC appears to believe that the expansive definition of financial commitment is warranted by its conclusion in Release 10666 that “all contractual obligations to pay in the future for consideration presently received” may involve the issuance of senior securities. However, the SEC made that statement in the context of analyzing specific types of trading practices that were designed for “speculative purposes or to accomplish leveraging.” This statement in Release 10666 was not designed to stand for the proposition that all contractual obligations to pay in the future constitute senior securities for purposes of Section 18.

Firm commitment agreements of the type described in Release 10666 are quite different from unfunded capital commitments, regardless of any cursory similarity to an agreement (as described in Release 10666) that is “a buy order for delayed delivery in which an investment company agrees to purchase a Ginnie Mae from a seller . . . at a future date, stated price, and fixed yield.” For example, Release 10666 notes that “[a]greements frequently permit substitution of a different Ginnie Mae with a stated yield different from the contract rate, so long as there is an appropriate adjustment to the purchase price that results in a yield to expected maturity equal to the yield originally committed.” No such substitution may be made in an unfunded capital commitment.

More significantly, Release 10666 addressed how these types of agreements could create the leverage that Section 18 was designed to address: because the value of the security that the RIC had committed to purchase could fluctuate prior to settlement because of interest rate changes, the RIC would have the opportunity to realize gains or losses on the

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8 *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1979)] (“Release 10666”).

9 *See* Proposing Release at 16 (quoting Release 10666).

arrangement – gains or losses that the RIC could realize by closing out the purchase obligation. In Release 10666, the SEC stated that "[w]hether or not a firm commitment is held until settlement, it creates the potential for profit or loss without any investment because interest rate changes in the marketplace affect the value of the security to be delivered. In economic reality, this can be characterized as unlimited leverage."

An unfunded capital commitment presents no such opportunity. The amount of the obligation is dependent on the amount of capital that is yet to be drawn. While the value of the RIC's limited partnership interest may fluctuate based upon the amount of capital that has been invested in the private fund, there will be no profit or loss on the unfunded commitment. It certainly does not present the opportunity for the types of profits or losses addressed in Release 10666.

In summary, Section 18 is intended to limit leverage and, therefore, if the SEC is concerned about an evasion of Section 18, the SEC should focus only on those transactions that create leverage. Private fund commitments do not create leverage – the concern that is at the heart of Section 18 and Release 10666.

IV. Matching Future Private Fund Commitments Is a Liquidity Management Issue

We acknowledge that the SEC may have concerns over whether a RIC will have sufficient assets to meet its obligations as they come due.[10] In the PEGCC's view, this risk is best addressed through guidance reminding RICs of the importance of liquidity management. The SEC took this approach in its recent proposal to require open-end funds to adopt liquidity management programs.[11] While the PEGCC does not believe that such a rule is required for closed-end RICs (and does not take a position on the proposed liquidity management rule generally), the SEC may conclude that it should provide a reminder to closed-end RICs of the importance of maintaining adequate liquidity to meet financial obligations. In fact, the SEC acknowledges that the Proposed Rule overlaps in some respects with the proposed liquidity rule.[12] The SEC notes that the Liquidity Release would require funds to consider certain specified factors in classifying the liquidity of its portfolio positions and that funds "could use this analysis" for purposes

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[10] The Proposing Release repeatedly refers to Section 1(b)(8) of the Investment Company Act, which states that the national public interest and the interest of investors are adversely affected when investment companies "operate without adequate assets or reserves."

[11] *See* Open-End Fund Liquidity Risk Management Programs; Swing Pricing, SEC Release Nos. 33-9922, IC-31835 (Sep. 22, 2015) (the "Liquidity Release").

[12] *See* Proposing Release at 241; Liquidity Release.

of the Proposed Rule.[13] We believe that this type of guidance, in whatever form, would provide a more effective and appropriate means of addressing this concern.

V. Asset Segregation Requirement

A. *The Amount of Assets Required to Be Segregated Should Be Narrowly Tailored to Meet the SEC's Objectives*

Notwithstanding the comments above, if the SEC concludes that an unfunded capital commitment should be treated as a financial commitment transaction, then a RIC should not be required to segregate an amount equal to the total unfunded obligation under a capital commitment to a private fund. An uncalled capital commitment is not a "current" liability of the RIC and is contingent on the private fund manager's decision to draw down the commitment.[14] The accounting treatment under U.S. GAAP is based on the contingent nature of uncalled capital commitments, since the uncalled capital commitments are not required to be reflected as a liability on the RIC's balance sheet until the capital is called by the private fund. Therefore, an asset coverage amount equal to the full notional value of the unfunded commitment significantly exceeds the amount of liquid assets that the RIC would likely need at any given time to meet its obligations as they come due. Given that a capital commitment may not be drawn down for a substantial period of time, there does not appear to be any reason for the RIC to maintain the liquid assets necessary to meet the commitment until it can be expected to be drawn on. We believe that any requirement to maintain qualifying coverage assets should be narrowly tailored to achieve the Proposed Rule's stated purpose of ensuring a RIC's ability to meet its obligations.

Thus, the SEC should consider an alternative approach that could require a RIC to segregate a "risk-adjusted" amount, taking into account the uncertainties concerning the timing and likelihood of future payments under the capital commitments. This approach would be similar to the approach taken with respect to the Proposed Rule's asset segregation requirements for derivatives transactions. For example, the RIC could estimate the likelihood that a commitment could be drawn in a calendar quarter, and segregate that amount of assets.

Furthermore, the PEGCC believes that a RIC should be able to cease treating any remaining portion of an unfunded capital commitment as a financial commitment transaction once the private fund's investment period has terminated. As a general matter, under these circumstances the capital commitment may only be called for limited

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[13] *See* Proposing Release at 242.

[14] The aggregate amount of unfunded commitments is disclosed as a contingent liability in the notes to the investing fund's financial statements, but is not reflected in the balance sheet itself.

purposes. The SEC's concerns with respect to both leverage and sufficiency of assets would be minimal while the determinations that the RIC would have to make in estimating the amount that might be drawn would be speculative at best. If the SEC does not want to provide this type of bright line, easy to apply test it should at least confirm that a RIC can take this factor into account under the type of tailored risk-adjusted approach described above.

B. Composition of Qualifying Coverage Assets

Similarly, if the SEC concludes that an unfunded capital commitment should be treated as a financial commitment transaction, we recommend that the SEC clarify that eligible qualifying coverage assets would include any assets (including equity securities) that could be sold for, or otherwise converted into, cash prior to a RIC's reasonable expectation of its payment obligations under its unfunded capital commitment. The SEC commentary in the Proposing Release could be interpreted as limiting the "assets convertible to cash" to include only fixed-income securities. We believe that "assets convertible to cash" should include a broader range of liquid assets, including liquid equity securities, consistent with the Merrill Lynch no-action letter.[15] So long as a security with sufficient value can be liquidated for cash before the RIC is required to pay its unfunded capital commitment, the RIC is not exposed to the risk that it would be unable to meet its payment obligations and should therefore be permitted to use the security as a qualifying coverage asset.

In addition, if a RIC is required to segregate liquid assets, we believe that the borrowing limit under the investing fund's line of credit should be counted toward the amount of qualifying coverage assets required to be maintained. A RIC that has obtained a line of credit, which may be used to meet its obligations under financial commitment transactions, has a means of ensuring its ability to meet those obligations as they come due. Furthermore, if an uncalled capital commitment is viewed as a senior security, a RIC would not be adding any leverage by utilizing a line of credit, since on any occasion when the RIC draws down the line of credit, the amount of uncalled capital commitment would be decreased by the same amount.

VI. Unforeseen Impacts and Transition Period

If the Proposed Rule is adopted in its current form, many RICs, including RICs that invest substantial portions of their assets in private funds, would have to significantly alter their investment policies in order to reflect the asset segregation requirement.[16] This

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[15] *See* Merrill Lynch Asset Management, L.P., SEC No-Action Letter (pub. avail. July 2, 1996).

[16] The white paper accompanying the Proposed Rule does not make clear to what extent the Division of Economic and Risk Analysis assessed the impact of the Proposed Rule on RICs that have significant unfunded capital commitments. *See* DANIEL DELI ET AL., Use of Derivatives by Registered

could have a significant impact on the expectations of investors in such a RIC (as a significant portion of its assets would have to be invested in cash-like investments). Such a RIC would have to consider whether it needs to modify its investment policies, liquidate or explore whether it could deregister under the Investment Company Act, since the RIC might not be able to meet the expectations of its investors.

This outcome would be particularly regrettable, since certain of these RICs may limit their investors to sophisticated accredited investors.[17] These RICs have become an attractive means of making the investment returns experienced by private funds available to such investors in a RIC that is managed by a sophisticated investment manager – a result fully consistent with the Investment Company Act. We suggest that the SEC consider whether the "undue speculation" and "asset sufficiency" rationales support limitations on the use of unfunded capital commitments by such RICs.

We also suggest that the Proposed Rule, if adopted, "grandfather" existing unfunded capital commitments and not subject them to the asset segregation requirement. This would limit the current impact of the Proposed Rule on existing RICs and their shareholders. In addition, the SEC should provide such RICs with a lengthy transition period (of at least five years) to adapt to the Final Rule. Five years may be sufficient to provide the Boards of Directors of such RICs time to consider the ramifications of the Proposed Rule on the RIC's investment policies, as well as provide shareholders with an opportunity to assess the impact of the Proposed Rule on their existing investments.

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Investment Companies, Division of Economic and Risk Analysis (Dec. 2015), available at https://www.sec.gov/dera/staff-papers/white-papers/11dec15_derivatives.html.

17 We understand that the SEC staff has taken the position that a registered fund of private funds can be offered only to accredited investors, even when its offering is registered under the Securities Act of 1933.

The PEGCC appreciates the SEC's consideration of this letter and is available to discuss any questions that the SEC may have.

Respectfully submitted,

Jason Mulvihill
General Counsel
Private Equity Growth Capital Council