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

24 March 2020

Re: Request for comment on Use of Derivatives by Registered Investment Companies and Business Development Companies; Required Due Diligence by Broker-Dealers and Registered Investment Advisers Regarding Retail Customers' Transactions in Certain Leveraged/Inverse Investment Vehicles (Release No. 34-87607; IA-5413; IC-33704; File No. S7-24-15)

Dear Ms. Countryman:

Ernst & Young LLP is pleased to provide comments to the Securities and Exchange Commission (Commission) on its re-proposal related to the use of derivatives by registered investment companies (RICs) and business development companies (BDCs) (collectively, funds).

We support the Commission's objective to modernize its regulation of funds' use of derivatives and other transactions addressed in the proposal. However, we recommend that the Commission clarify certain aspects of the proposal relating to the computation of asset coverage, as defined in section 18(h) of the Investment Company Act of 1940 (1940 Act).[1] These clarifications would help preparers and auditors more effectively discharge their responsibilities when computing and auditing a fund's asset coverage per unit, as required by Item 4.3 of Form N-2.[2] In addition, we also provide a recommendation relating to the disclosure of asset coverage for the Commission's consideration in its future rulemaking activities.

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1 Section 18(h) of the 1940 Act defines "asset coverage of a class of senior security representing an indebtedness of an issuer" as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer," and it defines "asset coverage of a class of senior security of an issuer which is a stock" as "the ratio which the value of the total assets of such issuer, less all liabilities and indebtedness not represented by senior securities, bears to the aggregate amount of senior securities representing indebtedness of such issuer plus the aggregate of the involuntary liquidation preference of such class of senior security which is a stock."

2 Item 4.3 of Form N-2 requires a registrant to furnish certain information for each class of its senior securities for the last 10 fiscal years, including asset coverage per unit, and such information must be audited for at least the last five fiscal years in accordance with Instruction 8 to Item 4.1 (Instruction 1 to Item 4.3 refers to Instruction 8 to Item 4.1).

Excluding derivatives transactions when computing asset coverage

The proposal states that if a fund satisfies the conditions of paragraph (c) of proposed rule 18f-4, the derivatives transactions[3] that the fund enters into in compliance with this section would not be considered for purposes of computing asset coverage, as defined in section 18(h) of the 1940 Act. In addition, the proposed amendment to Instruction 2 to Item 4.3 of Form N-2 states, in part, that a fund should not consider any derivatives transactions that it enters into in compliance with rule 18f-4 under the 1940 Act for purposes of computing asset coverage.

We recommend the Commission clarify how a fund should not consider derivative transactions for purposes of computing asset coverage, specifically whether and how funds should exclude assets and liabilities related to a derivatives transaction. For example, if a fund writes an option and receives a cash premium of $100, it initially recognizes the transaction by recording a cash asset of $100 and a written options liability of $100. The Commission should clarify whether upon initial recognition the fund should exclude from its asset coverage computation (1) both the $100 asset and the $100 liability or (2) only the $100 liability.

Furthermore, the Commission should consider clarifying how the subsequent measurement of the derivative liability and any income or loss from any proceeds received in connection with the derivatives transaction should be considered for purposes of computing asset coverage. For example, if the same fund described above is permitted to invest the cash premium received of $100, earns $1 of income on its investment and subsequently measures the fair value of its written option liability at $103, the Commission should clarify whether the fund would exclude from its asset coverage computation (1) only the derivative liability of $103, (2) the derivative liability of $103 and the initial cash asset received of $100, (3) the derivative liability of $103 and $101 in assets (representing the initial proceeds received plus the income earned thereon), or (4) some other amount(s).

Including derivatives transactions when computing asset coverage

We recommend the Commission clarify how funds should determine "the amount of senior securities representing indebtedness" included in the denominator of their asset coverage calculations if they do not satisfy the conditions in proposed rule 18f-4 to exclude derivatives transactions from their asset coverage computations.

For example, footnote 215 in the proposing release describes the Commission's views on BDCs' current practices of computing "the amount of senior securities representing indebtedness" in the denominator of their asset coverage computations when BDCs enter into derivatives transactions. The Commission states that it believes "the amount of senior securities representing indebtedness" is the notional amount of a derivatives transaction less any posted cash collateral and not the market value of the derivatives transaction.[4]

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3 The proposed rule would define a derivatives transaction as (1) any swap, security-based swap, futures contract, forward contract, option, any combination of the foregoing, or any similar instrument under which a fund is or may be required to make any payment or delivery of cash or other assets during the life of the instrument or at maturity or early termination, whether as margin or settlement payment or otherwise; and (2) any short sale borrowing.

4 Footnote 215 in the proposing release states, in part, "For purposes of calculating asset coverage, as defined in section 18(h), BDCs have used derivatives transactions' notional amounts, less any posted cash collateral, as the 'amount of senior securities representing indebtedness' associated with the transactions. We believe this approach — and not the transactions' market values — represents the 'amount of senior securities representing indebtedness' for purposes of this calculation."

If the Commission believes that funds that would not satisfy the conditions in proposed rule 18f-4 should use the methodology described in footnote 215 to determine "the amount of senior securities representing indebtedness," the Commission should include a statement to this effect in the adopting release.

Future rulemaking considerations — asset coverage reported in the senior securities table

We are providing the following recommendation for the Commission to consider in its future rulemaking activities.

Sections 18(a) and 61(a) of the 1940 Act prescribe asset coverage requirements for closed-end funds and BDCs and describe certain percentage limitations that if breached would, for example, prevent the closed-end fund or BDC from issuing any classes of senior securities or selling any securities of which it is the issuer and from declaring dividends or other distributions until it is able to comply with the percentage limitations.[5]

Item 4.3 of Form N-2 requires the disclosure of an audited asset coverage per unit, which has to be expressed for each class of senior securities in terms of dollar amounts per share (in the case of preferred stock) or per $1,000 of indebtedness (in the case of senior indebtedness) (Method 1), in lieu of being expressed in terms of a ratio (i.e., a percentage), as described in section 18(h) of the 1940 Act (Method 2).

Since sections 18(a) and 61(a) of the 1940 Act refer to asset coverage percentage thresholds that if breached would result in limitations on certain activities, such as those described above, the Commission should consider, as part of the Division of Investment Management's Investor Experience Initiative,[6] requesting comment from investors on whether they would prefer that closed-end funds and BDCs disclose asset coverage using Method 2 instead of Method 1 or that these entities disclose asset coverage using both Method 1 and Method 2.

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

Very truly yours,

Ernst + Young LLP

Copy to:

Ms. Alison Staloch, Chief Accountant, Division of Investment Management

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5 For example, section 18(a)(1) of the 1940 Act states, in part, that it is unlawful for any registered closed-end company to issue any class of senior security or sell any such security of which it is the issuer, unless, if such class of senior security represents an indebtedness, it will have an asset coverage of at least **300 per centum** [emphasis added] immediately after such issuance or sale.

6 See keynote address given by Dalia Blass at the ICI Mutual Funds and Investment Management Conference on 18 March 2019, https://www.sec.gov/news/speech/speech-blass-031819.