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NASAA

November 2, 2015

The Honorable Jeb Hensarling
Chairman
House Committee on Financial Services
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
House Committee on Financial Services
Washington, D.C. 20515

Re: November 3, 2015 Full Committee Markup of the Draft Legislation entitled "The Small Business Credit Availability Act"

Dear Chairman Hensarling and Ranking Member Waters:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I write to offer comments on a bill, the "Small Business Credit Availability Act," that is expected to be offered during tomorrow's Committee markup. The bill would relax portfolio strictures, leverage limits, and other regulations for business development companies ("BDCs"). NASAA commented on similar language in three bills proposed in October 2013,[2] and in a hearing of the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises on June 16, 2015.[3]

BDCs are regulated, closed-end investment firms that invest in small, developing or financially troubled companies. Although governed by the Investment Company Act of 1940 ("ICA"), BDCs are unique in that they enjoy a number of important exemptions from the ICA. For instance, BDCs are permitted to use more leverage than a traditional mutual fund – up to and including a 1-to-1 debt-to equity ratio, and BDCs can engage in affiliate transactions with portfolio companies. BDC managers also have access to "permanent capital" that is not subject to shareholder redemption. In exchange for such regulatory latitude, BDCs must adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs are required to maintain an asset coverage ratio of 200%, at least 70% of which must be in "eligible" investments.[4] In addition, under Section 12(d)(3) of the ICA, a BDC

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] Testimony of A. Heath Abshure, October 23, 2013, "Legislation to Further Reduce Impediments to Capital Formation," available at http://www.nasaa.org/27276/legislation-reduce-impediments-capital-formation/.

[3] NASAA letter dated June 15, 2015, available at http://nasaa.cdn.s3.amazonaws.com/wp-content/uploads/2013/10/NASAA-Letter-Regarding-June-16-2015-HFSC-Subcommittee-Hearing.pdf.

[4] Eligible investments include: (1) privately issued securities purchased from "eligible portfolio companies," (2) securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director, (3) privately issued securities of companies subject to a bankruptcy proceeding, or otherwise unable to meet their obligations, (4) cash, government securities or high quality debt securities maturing in less than one (5) facilities maintained to conduct the business of the BDC, such as office furniture and equipment, interests in real estate and leasehold improvements.

generally cannot acquire securities issued by a broker-dealer, an underwriter or an investment adviser of an investment company, or a registered investment adviser, except under limited circumstances.

Section 2: BDC Ownership of Securities of Investment Advisers and Financial Companies

NASAA has concerns about Section 2 of the bill, which would allow BDCs to invest in investment advisers and certain financial companies. We are also concerned with language that would redefine an "eligible portfolio company" as an investment company other than a private equity company or hedge fund, and the resulting diversion of BDC funds from the companies that BDCs were intended to benefit.

Section 2(a) of the bill would require that the U.S. Securities and Exchange Commission ("SEC") codify a no action letter that allowed one BDC to own a specified registered investment adviser.[5] This bill would mandate that broad, blanket authority be provided to all BDCs to invest in and own investment advisers and financial companies. Moreover, the bill does not provide the SEC with additional, explicit authority to address potential conflicts of interest. NASAA is concerned with such potential conflicts. For example, if an advisory firm were among a BDC's portfolio of companies, an incentive could exist for the investment adviser to recommend, or even push, clients toward investments in the BDC or its other portfolio companies. Such conflicts of interest could be even more troublesome in the context of an investment adviser's discretionary or "managed" accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. These inherent conflicts could interfere with an investment adviser's fiduciary duty obligations to its clients and the BDC as a shareholder. Allowing such potential conflicts of interest are also contrary to the express purpose and activities of BDCs. Competition from financial firms will not benefit traditional BDC portfolio companies, and may allow a BDC to access the advisory firm's pool of capital to shore up an underperforming portfolio company. No such conflicts of interest exist now, and NASAA urges Congress not to enact legislation that would result in such conflicts as it considers reforms to BDC portfolio strictures.[12]

The proposed bill could also have an adverse impact on BDC transparency, and increase the risk to retail investors. Sections 2(b) and 2(c) would continue to redefine an "eligible portfolio company" as almost any type of investment company other than a private equity company or hedge fund, and provides that a BDC may invest up to 50% of its "total assets" (20% more than currently allowed) in any type of eligible or non-eligible company. NASAA has significant concerns regarding these proposed changes to BDC portfolio strictures. Because BDCs are frequently "blind pool" offerings, retail investors may only receive broad, vague disclosures about the underlying investment portfolio. It is these "retail" investors who would bear the loss if the BDC invested in riskier products such as payday lenders and installment programs, REITS, or other structured products.[6]

[5] The referenced no-action letter does not provide any facts or details about the circumstances of the relief granted.

[6] Under existing law, at least 70% of a BDC's total assets must be invested in allowable investments. Among such investments are securities issued by an "eligible portfolio company," a term that is narrowly defined. An "eligible portfolio company" includes domestic operating companies with no class of securities listed on a national securities exchange as well as securities listed on a national exchange so long as the company has a market capitalization of less than $250 million. Section 2(b) of the bill would include a number of previously excluded companies in the definition of an "eligible portfolio company" including: underwriters and brokers of securities, banks or insurance companies, small business lenders, firms engaged in consumer finance or purchasing receivables, inventory financing, mortgage financing, and entities whose business is owning oil and gas or mineral related assets. Section 2(c) of the bill would permit BDCs to invest up to 50% of their total assets in eligible or non-eligible portfolio companies—20% more than BDCs may currently invest in such companies.

Section 3: Expanding Access to Capital for Business Development Companies

NASAA has questioned the rationale for further relaxing the leverage limits applicable to BDCs.[7] Excessive leverage by some of our largest financial institutions was in part responsible for the problems we faced in the most recent financial crisis. In our June 2015, and previous testimony, we stated that because an increase in leverage increases the risk to investors, we would be disinclined to support such a change absent sufficient justification.

NASAA appreciates that the current bill incorporates several important improvements to the previous legislation. Specifically, the bill requires reporting and non-reporting companies to provide notice and disclosure about new asset coverage ratios; confirms the required approval by a majority of independent directors or general partners; and provides other protections to shareholders regarding a possible increase in leverage.[8] We believe that such protections are important and should apply in all instances, including the ability to resell stock back to the company following a change in asset ratio coverage.

NASAA understands that certain small and mid-sized operating companies may confront challenges accessing credit and investment capital where these challenges may not have existed in the past, and that in some cases, permitting BDC's to take on greater leverage to invest in such companies could benefit such companies and BDC shareholders. However, as NASAA and others have noted,[9] adjusting the leverage limits applicable to BDCs has inherent potential to put retail investors at significantly increased risk. NASAA's concerns in this regard are greatly exacerbated under the present bill due to its substantial, inexplicable relaxation of existing BDC portfolio restrictions. In our view, should Congress ultimately conclude that a modest adjustment to BDC asset coverage ratios for well-established BDCs is in order, it should carefully consider the increased risks that such changes could create for retail investors, and examine what if any steps can be taken to mitigate such risks.[10] NASAA would be pleased to work with Congress in this regard.

Section 3(a)(3) of the bill amends Section 61(a) of the ICA to allow BDCs to issue senior equity in addition to the current authorization to issue only senior debt. We question the necessity of issuing senior equity securities that will have greater preferences, including realized returns, over existing common shareholders. Section 3(a)(5) and 3(a)(6) of the bill is a restatement of the prior version of the bill which provided extensive relief from voting rights requirements and the right to elect directors in the event of default except in certain instances (i.e., where stock is issued to a person that is not a qualified institutional buyer). Congress should consider whether the relief should also be inapplicable to issuances of debt to investors that are not qualified institutional

[7] The current asset coverage ratio applicable to BDCs is 200%. This means that every dollar of a BDC's debt must be "covered" by two dollars of BDC assets, effectively limiting a BDC's leverage ratio to 50% of assets.

[8] The bill provides for two options: (i) it makes any change in the leverage ratio effective one year after director approval, and provides that for non-listed BDCs each person who is a shareholder as of the date of approval shall have a right to tender their equity securities as of that date, with 25% of the total outstanding securities available for repurchase in each of the four quarters following approval of the increased leverage; or (ii) at a special or annual shareholder meeting in which a quorum is present, the company receives the approval of more than 50% of the votes cast to increase leverage, whereupon the increase in leverage would become immediately effective. We believe that the protections provided in (i) should apply in all cases.

[9] As SEC Chair Mary Jo White noted in a letter to the Subcommittee when it was considering similar legislation to relax BDC leverage limits in October, 2013: "[An] increase in the ability of BDCs to use leverage, and the elimination of provisions of the [Securities] Act intended to protect holders of preferred stock issued by a BDC, gives rise to investor protection concerns, particularly because most BDC shareholders are retail investors." Letter from SEC Chair Mary Jo White to House Financial Services Subcommittee Chairman Scott Garrett and Ranking Member Carolyn Maloney. October 13, 2013.

[10] For example, Congress could require that any reduced leverage restrictions would only be available to seasoned BDCs that have demonstrated debt service capabilities for at least five years.

buyers. In addition, Section 3(a)(5) of the bill has been revised from earlier drafts to allow BDCs to issue multiple classes of debt securities and senior equity securities only to qualified institutional buyers. While NASAA appreciates that sales to institutional investors may mitigate certain risks in the issuance of stock broadly, the issuance of *any* additional senior equity securities will continue to dilute the economic value and voting rights of common stock, to the detriment of retail investors. We encourage Congress to require that if additional preferred stock is allowed, that it be counted as debt and not as equity. Finally, we also question the impact that removal of the word "voting" from 61(a)(3)(A) of the ICA (in Section 3(a)(4) of the bill) will have on common shareholders.

Section 4: Parity for Business Development Companies Regarding Offering and Proxy Rules

Finally, state securities regulators understand and support sensible modernization of regulations applicable to BDCs and other companies, and we support the proposal to extend the relaxed regulatory requirements available to Well Known Seasoned Issuers and certain other large public filers to BDCs. However, we believe that any rule revisions by the SEC should be required to be completed before making the provisions of this bill effective.

Thank you for considering NASAA's views on the legislation before the subcommittee. State securities regulators look forward to working with Congress on these and similar efforts to promote efficient capital formation and modernized investor protection frameworks. Should you have any questions, please do not hesitate to contact me.

Sincerely,

Judith M. Shaw
NASAA President and Maine Securities Administrator