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TESTIMONY OF

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Introduction to Franklin Square

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee, thank you for giving me the opportunity to testify today. My name is Mike Gerber and I am an Executive Vice President with Franklin Square Holdings, L.P., d/b/a Franklin Square Capital Partners ("Franklin Square").

Franklin Square, founded in 2007 and headquartered in Philadelphia, Pennsylvania manages alternative investment funds. Our mission is to enhance mainstream investors' portfolios by providing access to asset classes, strategies and asset managers typically available to only extremely wealthy individuals and large institutional investors. While our funds offer "endowment-style" investment strategies that help construct diversified portfolios and manage risk, we also strive to set the industry standard for best practices, with a focus on transparency, investor protection and education for investment professionals and their clients.

To execute on this mission of bringing institutional quality alternative asset management to mainstream investors, we launched the industry's first non-traded Business Development Company ("BDC"), FS Investment Corporation ("FSIC"), in January 2009. FSIC is now publicly traded on the New York Stock Exchange ("NYSE"), where we listed it in April 2014, creating liquidity for our investors. We also manage three other BDCs, all non-traded for the time being, as well as one non-traded closed-end fund. In all, we manage more combined BDC assets, in both traded and non-traded BDCs, than any other manager in the industry.[1]

Since launching our first fund, we have grown from 12 employees to over 270 employees, and now have offices in Orlando, Florida and Washington D.C. in addition to our headquarters in Philadelphia. Most importantly, our funds have performed well for our investors, providing strong, risk-adjusted returns, while at the same time, making much needed capital available to hundreds of U.S.-based job creating middle-market companies. Our investors hail from all fifty states, and to-date, because of Congress' vision when creating the BDC, we have invested in companies in thirty-nine states, representing hundreds of thousands of jobs.

A Brief History of BDCs

A BDC is a type of closed-end investment fund that was created by Congress through the enactment of the strongly bi-partisan Small Business Investment Incentive Act of 1980.[2] Congress's stated objective in creating BDCs was to encourage the establishment of new capital vehicles that would invest in, and increase the flow of capital to, small and mid-sized companies in the United States.[3] As such, the Investment Company Act of 1940, as amended (the "1940 Act"), generally requires BDCs to invest at least 70% of their total assets in the securities of "eligible portfolio companies," which the 1940 Act generally defines as private U.S. operating companies and public U.S. operating companies with market

[1] Franklin Square currently manages the following BDCs through affiliated entities: FSIC, which commenced investment operations in January 2009 and listed its shares of common stock on the NYSE in April 2014; FS Energy and Power Fund, which commenced investment operations in July 2011 and continues to raise capital; FS Investment Corporation II ("FSIC II"), which commenced investment operations in June 2012 (after FSIC's continuous public offering was closed to new investors) and closed to new investors in March 2014; and FS Investment Corporation III ("FSIC III), which commenced investment operations in April 2014 (after FSIC II's continuous public offering was closed to new investors) and continues to raise capital. Further, Franklin Square currently has two additional BDCs, FS Investment Corporation IV and FS Energy and Power Fund II, in registration with the U.S. Securities and Exchange Commission (the "Commission").
[2] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980); *see also* S. REP. NO. 96-958 (1980); H.R. REP. NO. 96-1341 (1980). The Act was approved by the U.S. House by a vote of 395-1 and by unanimous consent in the U.S. Senate.
[3] *See* S. REP. NO. 96-958, at 1, 3 (1980).

capitalizations of less than $250 million.[4] Consistent with Congress's goal of providing support to small and mid-sized U.S. companies, the 1940 Act also requires BDCs to make available significant managerial assistance to such portfolio companies.[5] In complying with these regulatory requirements, BDCs provide a significant level of capital and assistance to small and middle-market U.S. companies. In fact, today, BDCs from across the industry have more than $70 billion invested.

In addition to helping fill a void in the capital markets for small and middle-market companies, BDCs provide individual investors with direct access to highly-regulated, transparent private equity and private debt investment opportunities, which typically had been available only to wealthy individuals and institutional investors such as university endowments, foundations and pension funds.

BDCs Are Highly-Regulated and Transparent Investment Vehicles

BDCs are among the most highly-regulated investment vehicles in the marketplace and, because of the robust public disclosures required of BDCs under the Securities Act of 1933, as amended (the "Securities Act"), the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the 1940 Act and the rules and regulations promulgated by the U.S. Securities and Exchange Commission (the "Commission") thereunder, the activities of BDCs are fully transparent to regulators, investors, portfolio companies and the general public. Specifically, BDCs register their securities under the Securities Act on Form N-2, which requires extensive disclosures regarding, among other things, the issuer, the securities being offered, the issuer's investment objectives and strategies, risk factors relating to the issuer's securities and business and the issuer's financial condition. Additionally, BDCs are required to register a class of securities under the Exchange Act and, as such, are required to file periodic and other reports with the Commission thereunder, including proxy statements and Forms 10-K, 10-Q and 8-K. In fact, contained in every 10-Q and 10-K is a schedule of all of our investments, along with details regarding the investments such as the name of the portfolio company, the size of the loan or equity position, rates, and current price marks.

The Exchange Act also imposes reporting requirements on BDC directors, officers and principal stockholders with respect to their ownership of and transactions in the BDC's securities. Finally, the 1940 Act imposes additional public reporting requirements on BDCs, including the requirement that BDCs provide annual disclosure regarding their fidelity bond insurance coverage.

These extensive disclosure requirements provide regulators, investors and portfolio companies with an exceptionally high level of transparency into BDCs and, in our opinion, serve to assist investors in making informed investment decisions, minimize conflicts of interest and ensure that BDCs act in the best interests of their investors.

In addition to the robust disclosure requirements imposed on BDCs by the federal securities laws, BDCs are subject to significant substantive regulation under the 1940 Act and the rules and regulations of the Commission thereunder. Key elements of these 1940 Act protections include extensive regulations governing, among many other things, portfolio composition, determination of the fair value of investments (which must be completed by the BDC's board of directors at least quarterly), share pricing, director qualifications and independence, transactions with affiliates, bonding, capital structure, the approval of underwriting agreements and advisory agreements, the making of distributions to investors, custody of assets and codes of ethics.

[4] *See* 15 U.S.C. § 80a-2(a)(46), -54.
[5] *Id*. §80a-2(a)(48)(B).

Further, in addition to regulatory oversight by the Commission through the application of these federal laws, non-traded BDCs are also subject to regulatory oversight by the securities commissions or similar governing bodies of each of the 50 states and the District of Columbia through the review of their public securities offering documents and the imposition of suitability standards for investor participation in those securities offerings. Finally, broker-dealers involved in the distribution of BDC securities are subject to regulation by the Financial Industry Regulatory Authority, Inc., which provides an additional level of protection for investors.

Taken together, these and the various other regulations applicable to BDCs make BDCs one of the most transparent and highly-regulated investment vehicles available to investors today.

BDCs Are Key Middle-Market Lenders

While BDCs are an important source of capital for small businesses, they are becoming a critical source of capital for middle-market businesses as well.[6] At Franklin Square, because of our scale, we have become primarily focused on the middle-market, which is an increasingly important part of the American economy.

Nearly 200,000 U.S. businesses comprise the middle-market, which translates into one-third of America's private sector gross domestic product.[7] Middle-market businesses employ more than 47 million people,[8] or one out of every three workers in the private sector.[9]

Like all firms, middle-market companies were deeply affected by the Great Recession. Nonetheless, they outperformed larger firms by adding over 2 million jobs,[10] demonstrating the resiliency of the sector and its importance to the overall health of the U.S. economy.[11] In fact, according to a recent report by American Express and Dun & Bradstreet, middle-market firms, which the report defined as those firms with revenue between $10 million and $1 billion, created 2.1 million of the 2.3 million net new jobs added to the U.S. economy between 2008 and 2014.[12] Middle-market firms experienced a 4.4% expansion in employment, versus a 1.6% expansion at big business and a 0.9% decline in small business employment over the same period.[13]

Middle-market firms are the new engines of the U.S. economy. Over the last year, the middle-market reported a mean total revenue growth of 7.4% compared to a 2.9% growth rate for the S&P 500 for the same period.[14] In turn, the demand for capital among middle-market companies is still increasing. In its most recent middle-market indicator survey, the National Center for the Middle Market reported that 39% of middle-market companies expect to add more jobs in 2015.[15] The National Center for the Middle Market estimates this will translate into another 5.3% revenue expansion across U.S. middle-market firms over the next year.[16] Middle-market lenders, like BDCs, must be positioned to provide the capital necessary to fuel this anticipated growth.

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[6] The National Center for the Middle Market defines middle-market businesses as businesses with revenues between $10 million and $1 billion. *See*, 1Q 2015, Middle Market Indicator.
[7] 1Q 2015 Middle Market Indicator, National Center for the Middle Market.
[8] *Id*.
[9] *Id*.
[10] *Id*.
[11] *Id*.
[12] Middle Market Power Index, April 2015, American Express Global Corporate Payments and Dun & Bradstreet.
[13] *Id*.
[14] 1Q 2015 Middle Market Indicator, National Center for the Middle Market.
[15] *Id*.
[16] *Id*.

As banks faltered during the financial crisis and generally continue to pull-back on middle-market lending, BDCs have already stepped into the breach to provide much-needed capital. Since the beginning of the economic downturn during 2008 and 2009, the value of BDC loans in the marketplace have more than tripled.[17] Currently, BDCs have over $70 billion in outstanding loans, a significant portion of which have been made to middle-market firms.[18] Franklin Square's BDCs have deployed more than $27 billion alone, primarily to U.S. middle-market companies. Of that $27 billion, over $10 billion of our BDCs' investments have been made through direct lending relationships. A prime example of a company with which a Franklin Square BDC established a direct lending relationship is Dent Wizard, a market leader in automotive body repair and restoration, which is headquartered in Bridgeton, Missouri. Another is MetoKote Corporation, headquartered in Lima, Ohio. MetoKote is the industry leader in protective coating applications and, among other things, provides protective paint coating for automobiles and tractors, including John Deere products.

With the mandate of investing at least 70% of their total assets in U.S. small-cap and private companies, BDCs are uniquely positioned to provide the capital middle-market firms like Dent Wizard and MetoKote need to continue to grow revenue and create new U.S. jobs.

The "Small Business Credit Availability Act"

Franklin Square believes that the discussion draft of the "Small Business Credit Availability Act" includes several modest, common sense amendments that would enable BDCs to provide even more capital to small and middle-market U.S. companies, and do so in a manner that could increase returns and decrease risk for investors, all while maintaining the strong regulatory regime and transparency that separates BDCs from many of the other non-bank lenders in the marketplace.

The Great Recession changed many dynamics in the capital markets, as have new and more robust regulatory requirements. Small and mid-size U.S. businesses have struggled to access previously available sources of capital. Several non-bank lenders have emerged as significant providers of capital, but none as transparent and heavily regulated as BDCs. Franklin Square believes that the "Small Business Credit Availability Act," if enacted into law, would allow BDCs to play an even greater role in supporting the capital markets and more effectively fill the existing capital void that has hampered businesses and job growth.

Asset Coverage Requirement Changes

First, the Act would amend Section 61 of the 1940 Act to decrease the asset coverage requirement applicable to BDCs from 200% to 150%. This change would effectively raise the leverage limit for BDCs from the current 1:1 debt-to-equity ratio to just a 2:1 debt-to-equity ratio.

Franklin Square strongly supports this proposed amendment because we believe it is a modest change that would allow BDCs to provide more capital to small and middle-market U.S. companies in a responsible manner, while maintaining transparency and the other investor protections that have made BDCs appealing investment options.

Franklin Square also believes that, relative to other lenders in the marketplace, a 2:1 debt-to-equity ratio is conservative. Banks are currently levered in the high single digits to the mid-teens[19] and non-bank asset-

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[17] Small Business Investor Alliance: BDC Modernization Agenda, with data from Wells Fargo Securities, LLC.
[18] *Id*.
[19] Based on the Federal Deposit Insurance Corporation ("FDIC") Definition of Tier 1 leverage: Tier 1 (core) capital as a percent of average total assets minus ineligible intangibles. *See* http://www.bankregdata.com/, based on data from the Federal Reserve

based commercial lenders and hedge funds can employ as much leverage as the market will bear, far exceeding bank leverage ratios in many cases. Aside from these elevated levels of leverage, traditional banks, hedge funds and many other non-bank lenders provide far less transparency than BDCs. It is with this backdrop that we see the proposal to allow BDCs to go to 2:1 debt-to-equity ratio as a responsible, modest update to BDC law.

Importantly, BDCs could use the additional leverage to construct portfolios that are safer for investors. In the current low interest rate environment and under the current 1:1 leverage limitation, BDCs typically chose between two general investment strategies. The first strategy is to chase yield by investing in riskier portfolio companies or by investing further down in the capital structure of a portfolio company. The second strategy is to accept lower yields by investing in less risky businesses or by investing higher up in the capital structure of a portfolio company. An increase to the permissible debt-to-equity ratio would open up a third option. With slightly more leverage, BDCs could invest in safer assets that generate less yield, but use the additional leverage to generate higher returns for investors.

For all three of these reasons, Franklin Square supports this key element of the discussion draft currently before the subcommittee.

Franklin Square also supports the provisions in the discussion draft requiring any BDC that plans to adopt the reduced asset coverage requirement to obtain board approval and then either obtain shareholder approval or undergo a one-year waiting period following notice of board approval before making a leverage change. Additionally, we support the requirement that non-traded BDCs provide quarterly liquidity to security holders as of the date of notice of such board approval. We believe that this one year "cooling off" period to allow investors in traded and non-traded BDCs to exit their investments before the BDC exceeds the existing 1:1 threshold is an improvement over previous versions of this legislation. As the largest manager of non-traded BDC assets, we believe that it is imperative to provide shareholders in non-traded BDCs with ample opportunity to exit their investments before a BDC exceeds the existing 1:1 debt-to-equity limitation.

Franklin Square believes that there are certain misconceptions about the leverage provisions of the proposed legislation that should be addressed. First, we do not believe that every BDC would choose to, or even be able to, take advantage of the reduced asset coverage requirement. For those BDCs that wish to take advantage of the reduced requirement, there are several natural governors in place that may limit the amount of additional leverage they may employ and, in some cases, prevent them from employing any additional leverage at all. We also believe it is safe to say that no BDC will move to the maximum allowable leverage of 2:1.

The first natural governor on leverage is the cushion many BDCs maintain between actual leverage and the leverage limit because of their floating net asset values ("NAV"). BDCs' NAVs fluctuate as a result of market and other conditions and, as such, so do their leverage ratios. For this reason, most BDCs currently employ leverage in the 0.55:1 to 0.80:1 range, well below the regulatory maximum of 1:1.[20] Franklin Square agrees with the industry analysts and rating agencies when they assert that BDC managers will maintain a similar buffer, around 1.65:1, if the statutory limit is increased to 2:1.[21]

The second natural governor on leverage is the compliance regimes established by bank regulators. In order to take on more leverage, BDCs must have banks that are willing and able to lend to them and

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Board ("Fed"), the FDIC and the Office of the Comptroller of the Currency ("OCC"). *See also* the FDIC Quarterly Banking Profile at https://www2.fdic.gov/qbp/2015mar/qbp.pdf.

[20] The BDC Almanac – Episode III, Wells Fargo Equity Research, January 22, 2014.

[21] *Id*; *see also* Fitch Wire: Leverage Limit Increase Could Differentiate BDC Ratings, Fitch Ratings, January 7, 2014.

agreements in place that permit the additional use of leverage. On that latter point, according to Fitch Ratings Inc., most credit facilities currently in place for BDCs include a covenant requiring the maintenance of a 200% minimum asset coverage ratio.[22] Therefore, in order to employ leverage above 1:1, BDCs currently subject to these covenants would be required to amend their credit facilities to reduce the asset coverage requirement to 150%. This amendment process for existing leverage facilities, and the establishment of any new facilities, would require banks to analyze BDC portfolios, BDC management teams and all of the other considerations that go into a bank's decision to extend credit to a BDC.[23]

Yet another natural governor on leverage is the rating agencies. Rating agencies review the underlying portfolios of BDCs when assigning credit ratings. BDCs that invest in highly leveraged assets, while increasing their overall leverage ratios, will have a more difficult time maintaining an investment grade rating.[24] Needless to say, BDCs with poor credit ratings will struggle to secure additional leverage.

Finally, institutional and retail investors, and the analysts that provide investors with research, serve as natural governors on leverage. Analysts and investors, particularly institutional investors, pay close attention to the performance of BDCs. Beyond looking at returns, the transparent nature of BDCs allows investors to frequently review a BDC's leverage ratio and portfolio composition. If analysts and investors do not like a particular BDC's mix of assets or its leverage levels, and the demand for shares in that BDC declines, the BDC will likely have to de-leverage to maintain a leverage ratio that is both compliant and more palatable to investors.

For all of these reasons, Franklin Square supports the proposal to reduce the asset coverage requirement from 200% to 150%. We believe this is a conservative and responsible change that would allow BDCs to provide more capital to small and middle-market U.S. companies, while maintaining low leverage ratios relative to other lenders in the marketplace.

<u>Offering and Proxy Rule Reforms</u>

Second, the proposal would direct the Commission to amend certain rules and forms promulgated under the Securities Act and Exchange Act to allow BDCs to use the more streamlined securities offering and proxy provisions that are already available to many other public companies. Specifically, these changes would make BDCs eligible for "Well-Known Seasoned Issuer" status and, therefore, eligible to file automatic shelf registration statements and permit BDCs to incorporate by reference reports and documents filed with the Commission into their registration statements and other public filings. These changes would help BDCs reduce administrative, legal and printing costs, and in turn, save money for investors. Importantly, this change would not make BDCs any less transparent than they are today. This provision of the bill has broad support and Franklin Square is in favor of including it in the legislation.

<u>Additional Provisions</u>

There are several other noteworthy provisions contained in the discussion draft including: (1) language designed to give BDCs additional flexibility in raising capital by permitting the issuance of preferred stock that would count against the BDC's overall leverage limit; (2) language to amend Section 60 of the 1940 Act to allow BDCs, under certain circumstances, to own securities issued by, and other interests in

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[22] *Id*.

[23] In particular, the asset quality and market risk provisions of the "CAMELS" ratings used by the Fed, the FDIC and the OCC to rate banks based on the performance of their loan portfolios. The acronym "CAMELS" refers to the six components of a bank's condition that are assessed: Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. *See* FDIC Quarterly Banking Profile, https://www2.fdic.gov/qbp/2015mar/qbp.pdf.

[24] *Id*.

the business of a registered investment adviser;[25] and, (3) language that would expand the definition of an "eligible portfolio company" to permit BDCs to increase exposure to investments in certain financial companies, but limit a BDCs investment in all financial companies to no more than 50% of any BDC's total assets.[26]

Each of these provisions has been modified to address concerns raised by managers, investors, analysts, lawmakers and the Commission. We applaud the efforts of Mr. Mulvaney and the Committee staff to modify these proposals, and we look forward to continuing to work with Mr. Mulvaney and the Committee on any additional improvements between now and the time of the markup.

Conclusion

BDCs offer a critical source of capital to small and middle-market U.S. companies. The proposed "Small Business Credit Availability Act" would position BDCs to play an even more substantial role in supporting these job-creating businesses. Franklin Square believes that middle-market companies in particular will continue to grow and drive the U.S. economy and that the time is right to modernize the regulation of the BDC sector to help support that growth. Key aspects of this draft legislation would allow BDCs to further increase capital flows to America's small and medium-size companies, spurring economic growth and job creation while maintaining the BDCs' position in the marketplace as a highly-regulated, transparent investment vehicle.

We thank Representative Mulvaney for his efforts in crafting this legislation, as well as Chairman Garrett and Ranking Member Maloney for their efforts to help modernize the BDC industry. Franklin Square stands ready to work with all the members of this subcommittee to advance this modernization effort. Again, we appreciate the opportunity to testify today and would be pleased to answer any questions.

[25] Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and the implementation of the rulemaking thereunder, an investment adviser to a private fund was not required to register with the Commission under the Investment Advisers Act of 1940, as amended, if it had fewer than 15 clients. As a result, BDCs were permitted to invest in these entities without violating the provisions of Section 12(d)(3) of the 1940 Act. The Dodd-Frank Act eliminated this exemption from registration and required BDCs to essentially stop investing in RIAs and, in the case of BDCs with existing RIA investments, to sell those RIA assets if the BDCs were unable to obtain exemptive relief from the Commission. Franklin Square does have concerns about conflicts of interests in cases where BDCs own RIAs. However, the Commission has been granting exemptive relief to RIAs on a case-by-case basis even without this statutory change and the discussion draft explicitly recognizes the Commission's authority to promulgate rules regarding such conflicts of interest. Because the Commission will continue to have authority regarding conflicts, Franklin Square does not oppose this provision in the draft bill.

[26] Specifically, those financial companies exempted from the 1940 Act under paragraphs 3(c)(2) through 3(c)(6) and 3(c)(9). Under current BDC law, such investments (along with those in paragraphs 3(c)(1) and 3(c)(7)) are considered non-qualified, meaning they do not qualify under the mandate that requires BDCs to invest at least 70% of their assets in private or small-cap operating companies. The proposal would treat these financial company investments as qualified assets, but limit them to no more than 50% of the BDC's total assets. Franklin Square believes that the current language, which would keep investments in 3(c)(1) and 3(c)(7) entities as non-qualified, is a significant improvement over the original version of the legislation that did not include such a limitation.