LEGISLATIVE PROPOSALS TO MODERNIZE BUSINESS DEVELOPMENT COMPANIES AND EXPAND INVESTMENT OPPORTUNITIES

HEARING

BEFORE THE

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LEGISLATIVE PROPOSALS TO MODERNIZE BUSINESS DEVELOPMENT COMPANIES AND EXPAND INVESTMENT OPPORTUNITIES

Tuesday, June 16, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:17 p.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Neugebauer, Huizenga, Duffy, Stivers, Fincher, Hultgren, Ross, Messer, Schweikert, Poliquin; Maloney, Sherman, Hinojosa, Lynch, Scott, Himes, Carney, and Murphy.

Ex officio present: Representative Hensarling.

Also present: Representative Mulvaney.

Chairman GARRETT. Greetings. Good morning. I apologize for being late.

This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order. Today's hearing is entitled, "Legislative Proposals to Modernize Business Development Companies—also called BDCs—and Expand Investment Opportunities."

Without objection, the Chair has the authority to recess the subcommittee at any time.

Before we go to our panel, we will have opening statements. And I yield myself 2½ minutes.

Again, good morning, and I apologize for being a few minutes late. Today's hearing will continue our important work on considering legislative proposals that would modernize our Nation's securities laws in order to do what? To foster greater economic activity.

One of these proposals is a discussion draft that is being circulated right now by the gentleman from South Carolina, Mr. Mulvaney. And what would it do? It would modernize the regulation of BDCs, business development companies.

And what are BDCs? Well, BDCs are closed-end investment funds that have a statutory mandate to invest much of their capital in small and medium-sized businesses. As new regulations cause banks and other lenders to pull back from the small and midsized lending market—and we have heard that in other hearings—BDCs have played an increasingly important role in our economy and in that space.

While it has been 35 years since their creation, the regulatory regime for BDCs has not been meaningfully updated during that time. Mr. Mulvaney's bill, which includes several provisions that this committee has previously considered, would do a couple of things. It would enhance the ability of BDCs to deploy capital, and therefore create jobs and opportunities, as well, for literally thousands of businesses, and therefore also their employees.

Now, aside from that bill, we have a second bill. The second bill we will consider toady is H.R. 2127, the Fair Investment Opportunities for Professional Experts Act. And that was introduced by the gentleman from Arizona, Mr. Schweikert.

What would Mr. Schweikert's bill do? It would amend the definition of who qualifies as an accredited investor under the securities laws, and is therefore eligible to invest in certain private offerings.

And while the Dodd-Frank Act directed the SEC to review the current income and asset-based definition of what an accredited investor is, there is still substantial concern that the SEC could ultimately take action that would limit the number of Americans eligible to invest in private offerings, a market that right now has actually grown to over $1 trillion in recent years.

You see, investing in private companies should not be a privilege reserved only for the super wealthy. And so, Mr. Schweikert's bill would allow more Americans to have the opportunities to secure their financial future.

Taken together, these two commonsense bills would expand upon the previous work of the subcommittee in this very important area. And so again, I thank the two sponsors of the legislation, as well as the witnesses for the hearing today.

And with that, my time has expired. I yield to the ranking member for 5 minutes.

Mrs. MALONEY. Thank you so much, Mr. Chairman. And I thank all our panelists for being here today. We are examining two bills today: one to modernize the regulations for business development companies, or BDCs; and another to revise the definition of an accredited investor.

The BDC bill is very familiar to all of us in this Congress because we considered a similar bill in depth in the last Congress. Since then, I am pleased to say that we have made some very good progress on this bill, and the draft that we are considering today reflects input from the Democratic side of the aisle, the Republican side of the aisle, the SEC, and the BDC community.

I am hopeful that we all can get to a "yes" on this bill, which would increase the availability of capital for small businesses. It is an important bill for our economy.

We will also consider a bill by Mr. Schweikert to revise the definition of an accredited investor. How to draw the line between someone who is an accredited investor and someone who is not is one of the most difficult questions in all of securities law.

An accredited investor is someone who, in the words of the Supreme Court, can "fend for themselves and does not need the protections of the securities law." These sophisticated investors are allowed to buy unregistered securities, which are often more complex and riskier than public securities.

Unregistered securities are also less liquid than public securities, which makes these investments in unregistered securities harder to exit or sell. As a result, these investments are supposed to be limited to investors who can legitimately bear the economic risk involved in buying them. These investors are referred to as accredited investors.

Current law defines an accredited investor primarily by reference to a person's income or overall net worth. Someone whose annual income is greater than $200,000 is an accredited investor. Or if someone's net worth, excluding the value of his house, is greater than $1 million.

So the question really is, does this strike the right balance? Is everyone who meets these tests truly able to fend for themselves?

The SEC's Investor Advisory Committee recommended a new definition of an accredited investor last year that seeks to more accurately identify investors with enough financial sophistication to fend for themselves. And I think this proposal is a very good starting point for this discussion.

I look forward to hearing a discussion of the benefits and drawbacks of the Investor Advisory Committee's proposal versus Mr. Schweikert's proposal. This is an important debate to have.

So I thank Mr. Schweikert for putting it forward. And I would also like to thank Chairman Garrett for holding this hearing, and to thank all of our panelists.

Chairman GARRETT. The gentlelady yields back. And I thank the gentlelady for her comments.

At this point, we will turn to our panel. Again, I thank the panel for being with us today. And I see some familiar faces. For those other-than-familiar faces, let me just remind you that you will be recognized for 5 minutes. I think there is a button there in front of you to tell you the time to start, and also an indicator in front of you of some sort that will go down to 1 minute on the timing for that.

We are in a new room now, so we will see just how well the microphones are working. I used to always have to ask the people to pull the microphone close to you when you speak. But we will see how that works here now.

And finally, you will be recognized for 5 minutes, but of course you have already submitted your testimony, and that will be made a part of the record. So now we just yield to you for 5 minutes to summarize your testimony.

Mr. Arougheti, welcome to the panel. And we look forward to your testimony. You are recognized for 5 minutes.

STATEMENT OF MICHAEL J. AROUGHETI, CO-CHAIRMAN OF THE BOARD OF DIRECTORS, ARES CAPITAL CORPORATION

Mr. AROUGHETI. Great. Thank you.

Chairman Garrett, Ranking Member Maloney, thank you for the opportunity to testify today. I am Michael Arougheti, the co-chairman of the board of directors of Ares Capital Corporation, a BDC that has invested more than $20 billion in hundreds of small and medium-sized companies, creating tens of thousands of American jobs.

By way of reminder, Congress created BDCs in 1980 to encourage capital flows to small and medium-sized companies at a time when these businesses had limited options for securing credit. Now uniquely, the BDC model allows ordinary investors the ability to participate in capital formation for small companies, effectively funding Main Street.

Today, similar to 1980, commercial banks continue to exit the middle-market lending space. Perhaps the most striking recent example of this is GE Capital's exit from the lending space. As the seventh largest bank in the United States, this will surely have a further significant adverse impact on the small and medium-sized businesses who have traditionally borrowed from GE Capital, and obviously on the jobs that these businesses have contributed to the economy.

I am here today to express support for the draft of the Small Business Credit Availability Act, H.R. 3868, being offered by Mr. Mulvaney. We believe that the proposed bill will enable BDCs to more easily raise capital and to make loans to middle-market companies, while ensuring that BDCs continue to be appropriately regulated and subject to stringent standards regarding transparency, and obviously shareholder protection.

I think it is important to note that BDCs are not seeking any government or taxpayer subsidy or support.

Many of the challenges that we face as BDCs arise out of our peculiar place in the regulatory framework, regulated as mutual funds yet operating as operating companies. The draft bill builds on H.R. 1800 and other bipartisan efforts in the previous Congress to modernize this regulatory framework, and to ensure that BDCs can continue to fulfill their original congressional mandate.

The proposed bill contains five provisions, each of which we believe will enable BDCs to more effectively fulfill their congressional mandate.

First, the proposed bill contemplates an increase in the BDC asset coverage test from 200 percent to 150 percent, subject to the satisfaction of shareholder-friendly conditions such as extensive public disclosure and transparency, and either a shareholder vote or a "cooling-off period" following approval by the independent members of a BDC's board of directors.

We don't believe that this introduces more risk. Rather, it will allow BDCs to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test may ironically force certain BDCs to invest in riskier higher yielding securities in order to meet the dividend requirements of their shareholders.

We also believe that this change will grant borrowers greater financing alternatives at a reduced cost, and will benefit shareholders with more conservative and more diversified portfolios. Further, this change will enable BDCs to lend to a broader portion of the already underserved middle-market.

This proposed change would apply to BDCs the same leverage ratio as small business investment companies, but unlike SBICs, without putting any government capital at risk. Further, given that the House Small Business Committee just last week passed bipartisan legislation increasing the size of the SBIC program, the proposed change certainly seems reasonable.

It is also extremely modest relative to typical bank leverage in our country of 10-to-1 and sometimes greater. Under the current asset coverage test, most BDCs operate at leverage significantly less than allowed. And any prudent manager would likely continue this practice if the asset coverage ratio were to change.

Second, the proposed bill would allow BDCs to issue multiple classes of preferred stock, and solely for qualified institutional buyers, eliminate the requirement that holders of preferred stock have board representation. Had BDCs been able to raise capital during the post-2008 period by issuing preferred stock, many more loans could have been made to cash-starved companies to enable them to retain employees, and in some instances to remain in business.

Third, the proposed bill directs the SEC to make specific technical amendments to certain securities offering rules that make raising capital cumbersome and inefficient. And these rule changes are not controversial and would merely place BDCs on equal footing with non-BDCs.

Fourth, the proposed bill would allow BDCs to own registered investment advisers, which is a technical matter that is currently prohibited under the 1940 Act. Investments in IRAs enable money to be raised from third-party investors, which in turn could be deployed to small and medium-sized companies.

And fifth, the proposed bill would offer increased flexibility for BDCs to invest in a subset of entities currently limited by the 30 percent basket. Importantly, this provision would not allow the amount of the incremental increase in the 30 percent basket to be invested in private equity funds, hedge funds, or CLOs.

So in closing, I am very encouraged by the bipartisan focus on this very important initiative. And I look forward to working with Representative Mulvaney and Representatives Garrett and Maloney and the rest of the committee in moving these bills forward.

I would also like to applaud the committee's efforts to revisit the definition of accredited investor, which, like the BDC regulatory framework that we are discussing today, could indeed benefit from modernization.

And lastly, as a procedural matter, Mr. Chairman, if I could, I would like to introduce a letter into the record from one of our portfolio companies that was referenced in my written testimony.

[The prepared statement of Mr. Arougheti can be found on page 42 of the appendix.]

Chairman GARRETT. If it is part of your written testimony, it will be a part of the record.

Mr. AROUGHETI. Thank you.

Chairman GARRETT. Thank you.

From Main Street Capital, Mr. Foster?

STATEMENT OF VINCENT D. FOSTER, CHAIRMAN OF THE BOARD, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, MAIN STREET CAPITAL CORPORATION, ON BEHALF OF THE SMALL BUSINESS INVESTOR ALLIANCE (SBIA)

Mr. FOSTER. Good afternoon, Chairman Garrett, Ranking Member Maloney, and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises. I appreciate the opportunity to testify today on behalf of the Small Business Investor Alliance or SBIA. SBIA's members provide vital capital to small and medium-sized businesses nationwide, resulting in job creation and economic growth.

My name is Vince Foster, and I am chairman, president, and CEO of Main Street Capital Corporation, an SEC-registered BDC based in Houston, Texas. We are named Main Street for a reason. Main Street is who we are and where we invest.

As our name makes clear, we have invested in over 400 small and midsized companies. That amounts to more than $4 billion invested into growing businesses that were not able to adequately access capital through traditional financing sources. Like many BDCs, we focus on smaller businesses.

We partner with entrepreneurs, business owners, and management teams that generally provide one-stop financing alternatives. Currently, we are backing over 70 lower-middle-market companies headquartered in 24 States. More than half of these businesses have revenues of less than $25 million.

To illustrate this diversity, we have funded two of the fastest growing technology companies in Eugene, Oregon; the largest privately owned jewelry store chain in the Rocky Mountains headquartered in Twin Falls, Idaho; one of the largest Goodyear Tire retailers in the United States headquartered in Austin, Texas; the leading micro-irrigation design and installation company in the San Joaquin Valley headquartered in Delano, California; the leading FBO at the Indianapolis Airport; one of the largest fully-integrated precast concrete companies headquartered in San Antonio, Texas; and one of the only two independent producers of styrene butadiene rubber in the United States headquartered in Baton Rouge, Louisiana, just to name a few.

We have also invested in GRT Rubber Technologies headquartered in Paragould, Arkansas, which was founded in the 1880s and manufactures rubber products including conveyor belts. And Bridge Capital Solutions, headquartered in Hauppauge, New York, which operates Long Island's only licensed commercial check-cashing service, serving small businesses in New York.

Today, Main Street has small business investments in at least 15 of the 24 States represented by this committee. And we are just one of the over 34 BDCs that are a part of SBIA.

Small and medium-sized businesses need growth capital. BDCs are growing to fill that need. BDC loan balances have tripled since 2008, and are not slowing. Growing businesses are going to continue to need more capital. BDCs will benefit from modernization that small businesses will be the ultimate beneficiaries of reform.

BDCs are highly regulated and highly transparent. The public can look up and review every one of our investments.

The BDC industry is not seeking deregulation or any changes to the Dodd-Frank Act. We have earned investor trust and grown stronger in the face of economic calamity. We earned our good name, and we will work to keep it.

What BDCs do need is commonsense modernization. I might need Mike to help me lift this up. Look at this stack of paper. This is our SEC filing to issue stock. Hundreds of pages represent wasted money and manpower.

Here is what CIT, $50 billion versus our $1.5 billion, has to file to get the same result because they can incorporate their other SEC filings by reference, but BDCs cannot. Do 4 more inches of paper protect better than half an inch? No one is protected by the failure to modernize the rules for BDCs.

This discussion draft would fix this absurdity and make a host of other clearly needed reforms. These reforms are overdue and worthy of bipartisan support. We encourage the committee to act promptly.

This committee has clearly worked on a bipartisan basis to make other reforms and improvements. For example, almost every BDC in the industry wants the freedom to access the markets by increasing the regulatory cap on leverage from 1-to-1 to 2-to-1. Not everyone will make the change, but they want the freedom to adjust to changes in the market.

The proposal does this in a very smart fashion that adds meaningful investor protections while adding capacity for investing. The draft bill makes other smart reforms that can add investor protections with transparency.

Currently, BDCs can earn registered investment advisers. But it requires SEC exemptive relief. This means BDCs are playing by different rules, and the investors are in the dark.

Standardizing the relief makes a level playing field, and provides clarity for investors. This, too, is a smart reform that is worthy of bipartisan support.

The bill includes a number of other reforms. Many are technical, but they matter, particularly for smaller and growing BDCs.

Every section of this bill shows thoughtful collaboration and improvements from previous bills. As the committee works through any fine-tuning on the bill, SBIA would encourage the committee to continue to keep the process moving and work to get real reform signed into law this Congress.

I would welcome any questions that you may have for me. Thank you.

[The prepared statement of Mr. Foster can be found on page 62 of the appendix.]

Chairman GARRETT. Thank you.

And later on we will hear from the gentleman from Maine about whether he has any comments about the less use of paper products being produced. But we will wait for his comments later.

Next, from Franklin Square Capital Partners, Mr. Gerber is recognized for 5 minutes.

STATEMENT OF MICHAEL F. GERBER, EXECUTIVE VICE PRESIDENT, FRANKLIN SQUARE CAPITAL PARTNERS

Mr. GERBER. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee. Thank you for the opportunity to testify today. My name is Mike Gerber and I am an executive vice president with Franklin Square Capital Partners.

Franklin Square was founded in Philadelphia in 2007 with the mission of offering institutional quality alternative investments to mainstream American investors, while leading the industry in best practices, transparency, investor protection, and education. To that end, we launched the industry's first-ever non-traded BDC in 2009. We successfully listed that fund on the New York Stock Exchange in April of last year to create liquidity for our investors.

Today, we manage four BDCs and have more BDC assets under management than any other manager in the industry. Franklin Square has investors in all 50 States, and we have portfolio companies in 39 States. Importantly, we have delivered strong risk-adjusted returns for our investors.

As you all know, the 1980 law that created BDCs was passed with strong bipartisan support, and was designed to stimulate investment in U.S. companies by matching mainstream investors' capital with mainstream businesses. Because BDCs are designed for retail investors, they are appropriately heavily regulated.

In fact, whether traded or non-traded, BDCs are among the most highly regulated investment vehicles in the marketplace. And because of the extensive public filings, some of which you have seen right here, BDCs are fully transparent to regulators and investors alike.

Our culture at Franklin Square is to embrace this regulation. In fact, it is part of how we market ourselves to financial advisers and investors. Specifically, BDCs register shares under the 1933 Act, and elect treatment as a BDC under the 1940 Act. In addition, a BDC is subject to the 1934 Act as a public company, meaning it must file 10-Qs, 10-Ks, 8-Ks and proxy statements.

Contained in every Form Q and Form K is a schedule of all of our investments, along with details such as the name of the portfolio company, the size of the loan, the rate of the loan, and the current mark of the investment.

Other key protections include mandatory third-party custody of all BDC assets; a board of directors, the majority of whom must be independent; and board approval of key matters such as management fees and quarterly valuations. In addition, our non-traded BDCs are also regulated by FINRA and by the blue sky securities regulators in all 50 States.

Taken together, these laws and regulations ensure that BDCs are extremely transparent, minimize conflicts of interest, and provide investors with a high level of protection.

One of the key mandates under the law requires BDCs to invest at least 70 percent of their assets in U.S. private and small cap companies. As a result, our BDCs at Franklin Square provided a significant amount of capital to middle-market job-creating companies.

Middle-market businesses employ more than 47 million people, or one out of every three workers in the private sector. In fact, between 2008 and 2014, middle-market firms grew jobs by 4.4 percent versus 1.6 percent for big businesses, and unfortunately a 0.9 percent decline with small businesses.

And now 39 percent of middle-market companies say they expect to grow and add more jobs in 2015. Middle market lenders like BDCs, therefore, must be poised to provide the capital necessary to help fuel this anticipated growth.

Currently, there are 84 BDCs representing approximately $70 billion in investments. At Franklin Square we have deployed $27 billion since inception, including $10 billion in directly originated loans.

The primary tool offered by Mr. Mulvaney's legislation that would help BDCs support more job-creating middle-market companies is the increase in the debt-to-equity ratio from 1-to-1 to 2-to-1. We believe this increase in leverage is modest and makes sense for three reasons.

First, BDCs would have more capital available to meet the demand of middle-market firms, while keeping all of our investor protections in place. Second, this would permit BDCs, as Mr. Arougheti explained, to build safer portfolios, delivering the same or higher returns, while taking on less risk. And third, even with the proposed increase, 2-to-1 leverage would still be quite low when compared to other lenders in the capital markets.

For example, banks today are levered anywhere from 8-to-1 to 15-to-1, and hedge funds are levered in the mid-teens to low 20s. We believe it would be good public policy to increase the lending capacity of BDCs, and promote the more heavily regulated, more transparent BDC model.

The discussion draft contains several additional provisions which I address in my written testimony, and I would be happy to cover in Q&A. I would like to close by thanking Representative Mulvaney for his work on this legislation. And I look forward to answering questions from the committee.

[The prepared statement of Mr. Gerber can be found on page 73 of the appendix.]

Chairman GARRETT. Thank you.

Now from the Center for Capital Markets Competitiveness, Mr. Quaadman, welcome back to the panel. You are recognized for 5 minutes.

STATEMENT OF TOM QUAADMAN, VICE PRESIDENT, CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

Mr. QUAADMAN. Thank you, Chairman Garrett, Ranking Member Maloney, and members of the subcommittee.

Markets provide investors with the opportunity for return, and businesses with the potential to grow. Markets must have an even playing field and certainty in order to achieve these purposes. But we also live in a global economy.

So this past February, the Chamber released a report entitled, "International Markets: A Diverse System is the Key to Commerce," which was written by Professor Anjan Thakor of Washington University.

And what the report found was two things: first, for businesses to operate in this global economy, they need to have diverse forms of financing; and second, capital will go to those markets that are most efficient, and businesses will go to where the capital is.

Therefore, in this global competitive environment, we have to keep in mind that the United States is not the only destination for capital. Indeed others, including the European Union today, are currently considering proposals to make their market-based financing more efficient in order to spur their capital formation. So these bills and the hearings that the subcommittee has been holding this year are very timely.

The business development corporations are filling a void for the midsized businesses and provide an alternative means to raise capital as other options have dried up over the years. We want to thank Mr. Mulvaney for introducing the Small Business Credit Availability Act, and we support it.

While BDCs have only been in operation since 1980, it is only in the last few years that they have become an attractive means of capital formation for businesses. Indeed, the Chamber has supported past bipartisan efforts to increase BDC activity. And we believe that this bill addresses the concerns that were raised in prior legislative debates, as well as by the SEC.

This bill will provide greater capital and flexibility investments while still having BDCs as a regulated entity. BDCs will increase, but still on a limited basis.

The Chamber also supports robust disclosures and investor protections of BDCs so that retail investors have both the opportunity to understand the upside, as well as the risk of investing in BDCs. We believe that the Mulvaney draft bill achieves that purpose.

I would also like to address the H.R. 2187, the Fair Investment Opportunities for Professional Experts Act. We need to have limits to allow sophisticated investors to invest in private companies and to access complex investment vehicles. We need to do this to ensure that unsophisticated investors are not harmed.

The Chamber supports objective tests such as asset and income thresholds to determine accredited investors. Mr. Schweikert has thoughtfully pointed out that there may be some on the periphery who should be allowed in. And we have some suggestions on how to improve the bill.

First, those who are licensed and certified to sell securities should be considered to be a sophisticated investor, but with caps to ensure that their investments match their financial wherewithal. Secondly, we understand the intent behind the FINRA test and think it is an innovative way to get at the solution. However, the test is also subjective.

We would prefer that the SEC be authorized to study the issue. What are the characteristics of a sophisticated investor? What are some of the innovative ways to bring those in, in a safe manner? And then to have the SEC report back to this committee as to what those innovations should be. And that those should be brought in under limited circumstances.

Additionally, we have concerns on the language regarding the use of financial intermediaries conveying an accredited investor status to retail investors. While we understand the intent behind that provision, we are concerned that the exception will subsume the rule, that it will also place some unsophisticated investors at harm, as well as increase liability for financial intermediaries. But we think this is a good step forward, and we are happy to work with Mr. Schweikert to make the bill a reality.

The Chamber feels that these bills will enhance the competitiveness and increase opportunities for return, growth, and job creation. We look forward to working with the sponsors of this legislation, both bills, with the subcommittee, and to improve them as well as to include these vehicles into a JOBS Act 2.0 that we hope can become law in this Congress. Thank you.

[The prepared statement of Mr. Quaadman can be found on page 81 of the appendix.]

Chairman GARRETT. Thank you.

Finally, last but not least, Professor Brown. You are recognized for—

Mr. BROWN. "Jay" is fine.

Chairman GARRETT. There you go.

STATEMENT OF J. ROBERT BROWN, JR., PROFESSOR OF LAW, UNIVERSITY OF DENVER STURM COLLEGE OF LAW

Mr. BROWN. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, it is a privilege to be here today.

In addition to my position at the University of Denver Sturm College of Law, I also serve as the Secretary to the SEC's Investor Advisory Committee (IAC). The remarks I make, however, are my own, and do not necessarily reflect the views of the other members of the IAC.

With respect to H.R. 2187, the Fair Investment Opportunities for Professional Experts, and the definition of accredited investor, let me give a bit of context. The SEC's definition of accredited investor for individuals was set out in 1982. While the dollar amounts have largely remained unchanged, the financial landscape has undergone a tectonic shift.

The markets have of course grown in complexity. But most significantly has been the shift from pension plans to defined contribution plans. Almost everyone with retirement savings today has a 401(k) or an IRA. The result has been what I believe is a dramatic increase in individual responsibility for managing the retirement nest egg.

Likewise, the number of retirees is increasing rapidly. Every day, 10,000 Baby Boomers reach the age of 65, a trend that will continue until 2030. Many of these older investors are unsophisticated and lack, as one study put it, "even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees."

With the end to the ban on general solicitations, our retirees and other investors can now be offered unregistered investments through indiscriminate forms of mass marketing, including blast emails, ads on the Internet, infomercials, and seminars. So imagine our 85-year-old parent or uncle or friend who gets the unsolicited phone call or the pitch at a free lunch to invest in pre-IPO shares, or—I am from Colorado—the marijuana business. If that doesn't work, how about a children's television network or a company that is making a grandchild-safe alternative to the Internet?

All of this brings me to the definition of accredited investor. The definition needs to include those who are sophisticated and exclude those who are not.

In reforming the definition, I believe there is more agreement than disagreement. There is agreement that it should be changed to include the people who are, in fact, sophisticated. The recommendation of the SEC's Investor Advisory Committee has set out standards for when this should occur, basing sophistication on education, experience, and testing.

The dollar thresholds also need reexamination. It may mean increasing the amounts. It also may mean changing the way the amounts are calculated. Maybe some portion of retirement assets should be excluded from the calculation.

Even people who oppose changes to the numerical thresholds, I believe, are mostly worried that a sudden increase in the dollar amount will significantly reduce the number of accredited investors. But if the definition is reformed simultaneously to make the income and net worth standards a better predictor of sophistication and allow individuals to also qualify on the basis of education, experience, and testing, I believe that all sides in the debate will benefit.

With respect to H.R. 2187, my written testimony has a more complete critique. But let me just offer these observations. First, the draft legislative proposal does not deal with our 85-year-old parent or uncle or friend who is in fact unsophisticated and qualifies as accredited because of the net worth test.

Second, the bill treats as accredited whole categories of individuals, such as lawyers. Lawyers are not invariably rendered sophisticated as a result of education or practice area. Extending the definition to persons who are not sophisticated is of particular concern since these individuals are not required to meet the numerical thresholds and may not be in a position to withstand the loss.

Finally, a serious risk is that regulators charged with implementing this legislation will stop other efforts. The bill leaves out other groups that ought to qualify as accredited as a result of experience and education.

The SEC is working on a study in this area that ought to include some recommendations. The Commission is in a good position to achieve the grand bargain that I think is needed, and should be allowed to complete the process without legislative intervention.

Very quickly with respect to business development companies, I think that the increase in leverage proposed under the legislation will raise the risk profile for at least some of these companies. But disclosure is an appropriate method of addressing the issue.

My most significant concern is with the changes that would allow BDCs to redeploy a higher percentage of their assets away from operating companies to financial firms. In 1980, Congress, in adopting the legislation creating BDCs, sought to provide additional funding and managerial advice to operating companies.

Why these companies? As the House report said then, the committee is well aware of the slowing of the flow of capital to American enterprises, particularly to smaller growing businesses, that has occurred in recent years.

The importance of these businesses to the American economic system in terms of innovation, productivity, increased competition, and the jobs they create is of course critical, hence the need to reverse this downward trend is a compelling public concern.

I suspect that this is no less true today than it was in 1980, and that these companies remain critically important to our economy and the creation of jobs. I think that any reform in this area should not change the framework in a manner that may disadvantage the very kinds of companies that the legislation was originally intended to assist.

Thank you again for providing me with the opportunity to be here today.

[The prepared statement of Professor Brown can be found on page 48 of the appendix.]

Chairman GARRETT. I appreciate your comments.

I thank the panel. And at this point, I will recognize myself for 5 minutes for questions, and I will go in reverse order.

And again, I thank the gentleman from Arizona for his work on the accredited investors change of definition. I guess our one takeaway from Professor Brown is that lawyers are not sophisticated. Will we have consensus on that from everybody on the panel that lawyers are not sophisticated? Okay.

So, moving on from that degree of consensus, on the issue of accredited investors, isn't it somewhat an issue of fairness too, as far as having drawn a distinction in class as to who is allowed to have the opportunity to these investors versus which class of people in the country don't have the opportunity?

What I was thinking as I heard the professor talk was that those people that you were defining, the retiree or what have you, currently probably don't fit into that definition of accredited investor. But they have the opportunity to do all sorts of other investments with their money.

Mr. Foster showed the disparity between BDCs and public companies. And those public companies are available on all the exchanges and what have you.

And the unsophisticated investor can be making life-changing investments in all of those. Of course in most of those investments, you don't necessarily see the rate of return that you sometimes see in a BDC. I see some nods on that.

So is this—maybe I will throw it out to Mr. Gerber. Is this an issue of degree of fairness as far so this distinction that will be allowing those who should be able to have the opportunity to get into these investments who currently are precluded simply by law?

Mr. GERBER. Thank you, Mr. Chairman. Just a point of clarification—

Chairman GARRETT. I should probably not have thrown that to Mr. Gerber.

Mr. GERBER. No, that is okay. But I just think it may be important to mention this on behalf of the BDCs. To invest in a publicly traded BDC, a person does not need to be an accredited investor, number one.

Number two, to invest in a non-traded BDC, investors—that transaction is regulated by the blue sky laws in each of the States. And all of the States have their own suitability standards that apply to whether or not an investor is appropriate for—

Chairman GARRETT. So let me throw it over to Mr. Quaadman as far as the rest of the investment field.

Mr. QUAADMAN. Sure. Chairman Garrett, you raise a very good question, because we have a robust private company market.

Most businesses in the United States are private. So what we need to do is ensure that we have capital flows into those private companies to ensure that they have the liquidity to grow and operate.

What is also important is that with public companies, we have a vast amount of disclosure with the notion that investors can go in there and make whatever decisions they want because they can access the information.

What we want to do with the private companies is ensure that you have people with the knowledge base and the wherewithal to go in there and to invest in companies.

Chairman GARRETT. Let me stop you there and go back to Mr. Gerber then because he was saying that these are not—which is correct. It was with regard to accredited investors in BDCs.

Satisfy for me then that there is enough transparency, information, and the like for that class of non-accredited or non-sophisticated in that realm.

Mr. GERBER. With respect to BDCs, as I mentioned in my testimony, Mr. Chairman, we fall under the 1933 Act, the 1934 Act, and the 1940 Act. So in the BDC context, there is a load of transparency and a ton of information that is provided to investors, just the same as a publicly traded company.

Chairman GARRETT. So who is it when you are trading in these and—where has that information actually gotten to? In other words, where the investment is certainly done through your broker or what have you, in the securities in the street name, is that actually getting back to me as the nominal investor in that situation?

Mr. GERBER. It certainly can be. It is available on the SEC Web site EDGAR. It is available on all of our Web sites. So it is easily accessible.

Chairman GARRETT. So what about—and I will throw this to anybody else to talk about the BDCs. What about what is in Mr. Mulvaney's bill as far as changing the leverage ratio—the ratio? As far as getting sufficient transparency there back to the actual investor who may not actually be in the—may not actually be the street name investor? Anyone who wants to chime in on that?

Mr. AROUGHETI. Yes. I think we talked about this proposed legislation relative to prior attempts to increase the asset coverage ratio, I think the combination of a form of shareholder vote and a "cooling-off period" provides the adequate shareholder protection.

So as this bill contemplates, the independent board of directors would make a determination that they would like to access the increased asset coverage ratio. And then under the securities regulations, an 8-K would need to be filed publicly to make public notice of the intention.

And then obviously the shareholders will have 12 months of a cooling-off period to effectively vote with their feet. So even in the event that there wasn't a shareholder vote—

Chairman GARRETT. Right.

Mr. AROUGHETI. —it would give people free time to determine whether or not they wanted to stay within that investment.

Chairman GARRETT. Okay. Great. Thanks. I appreciate that.

I have some other questions with regard to the testing requirements, but I will throw it to the gentlelady from New York.

Mrs. MALONEY. Thank you, Mr. Chairman, for calling the hearing. And I thank all the panelists.

I would like to ask Mr. Arougheti about the additional leverage that the BDC bill would allow. Of course, we are still talking about very low levels of leverage.

The bill would only increase the maximum leverage ratio from 1-to-1 to 2-to-1. But it is still a higher leverage. What would your company do with the higher leverage that this bill would permit?

Mr. AROUGHETI. I think, as Mr. Gerber said in his testimony, it is not abundantly clear that every company will actually take advantage of the incremental asset coverage ratio.

I think one of the wonderful things about the BDC industry is that it services all types of companies from venture finance companies all the way through two larger middle-market companies. And even on this panel you have companies who focus on the lower middle-market with more equity orientation through to folks like ourselves who focus more on larger market senior secured loans.

So what Ares would likely do would be to increase the scope of its lending activities, probably become more senior secured and therefore less risky in our investment positioning, and use the increment to leverage, back to Mr. Gerber's commentary, to drive the same, if not higher returns to our investors but taking less risk at the asset level.

Mrs. MALONEY. So how much of the additional money would go to increase investments in the so-called 70 percent bucket for small businesses? It would give you more money to—more liquidity to put out to these smaller businesses.

Mr. AROUGHETI. Right. So, all of that capital should theoretically find its way to small business.

Maybe addressing at least for Ares the 30 percent basket as we use it has two concentrated positions in it today. One is called the senior secured loan program, which is a joint venture that we had with GE Capital that we used to actually make middle-market loans. And the second is in the form of a company that we call Ivy Hill Asset Management, which similarly is in the business of making middle-market loans.

So at least from the Ares strategic perspective, we have been using our "30 percent basket" to in fact make middle-market loans to small companies.

Mrs. MALONEY. I would like to ask you and also Mr. Foster about the discussion draft of the BDC bill, which would allow BDCs to invest more of their assets in finance companies. And as Mr. Foster testified, the intent of the first BDC bills was to direct these monies towards goods and services that are really underfinanced and need this help.

Are you concerned that this change could change how BDCs are viewed by investors and analysts? And what is your feeling about being able to invest more in finance companies as opposed to goods and services?

And I would like first to hear from Mr. Foster and Mr. Arougheti. But also any comments from anybody else on the panel on this question of allowing the finance companies.

Mr. FOSTER. Sure.

The BDCs in the SBIA have generally been polled by the staff. And in general there is a consensus with respect to the BDCs, the 34 BDCs in the SBIA—not 100 percent, but a general consensus is that this additional flexibility would be nice. It is not a priority at all.

And I don't think many of us would take advantage of it. We personally would not take advantage of it. I think you would do so at your own risk to the degree you alienated some of your shareholders or what have you by changing your business plan.

On the other hand, we are permanent vehicles for capital. And there is a constantly changing array of investment opportunities out there. And the credit cycle goes up and down.

So to me, it is kind of like the swimming pool in the backyard. I really don't use it, but it is nice to know it is there if I ever want to use it. And I think that is the general consensus of the SBIA.

Mrs. MALONEY. Mr. Arougheti, do you—

Mr. AROUGHETI. Yes. I think about this two ways, one just in the context of modernization.

And as we sit here today talking about legislation that was passed 35 years ago, while many things are still similar in terms of the capital void for middle-market companies, the structure of the financial markets has changed. And things like small ticket leasing, things like factoring, things like receivables financing, all exist today in a way that they didn't exist 30 years ago.

So as one example in our portfolio, we have a leasing company that makes office equipment leases to small business—

Mrs. MALONEY. Okay. My time has almost expired and I would like to hear Mr. Foster's reaction to it, too. I only have 7 minutes left. Excuse me—Mr. Brown's—

Mr. BROWN. My biggest concern is that there will be funds redirected away from operating companies and to these financial firms.

I don't know if financial firms need the funds in the same way that operating companies do. But there is a defined need here for operating companies. And I think before the legislation allows for the redirecting of funds away from those companies, it should have a stronger empirical basis for determining that, which is a more appropriate use of funds.

Chairman GARRETT. Thank you.

The gentleman from Texas is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Thanks for holding this hearing.

Mr. Arougheti, Mr. Brown had said that increasing the leverage ratio would be harmful to—has the potential to be harmful to the investors. But what I heard you saying is that you would use that leverage in a way that enhances shareholder value, wouldn't you?

Mr. AROUGHETI. Yes, I would. I believe, and I think it is just common knowledge in the investment business that the introduction of leverage could amplify risk the same way it could amplify returns.

So I would be remiss to say that there is not the possibility that it could theoretically improve risk. But what I believe Mr. Brown also said is that the benefits, provided there is adequate disclosure, which this legislation provides for, far outweigh those potential risks.

One thing I think is worth highlighting is that the structure of the market already accommodates the leveraging of lower risk assets.

In fact, within the BDC industry, where we borrow from banks they give us a schedule of investments identifying how much they are willing to leverage our various investments. And from that list, starting with common equity all the way up through senior secured loans, what you will see is a market's unwillingness to leverage equity investments and a market's willingness to leverage senior secured loans well in excess of the proposed 2-to-1.

So, outside of the BDC construct, the idea of risk-based leverage is pretty well-established. And even within the BDC framework, the existing leverage facilities are already in place to accommodate that changing leverage requirement if the 1-to-1 overlay were widened.

Mr. NEUGEBAUER. So, if this bill passes and becomes law, you don't see this big rush out to all these companies to leverage up because basically it is going to—you have a business model and there is certain amount of opportunity out there to determine how you can best fund that.

Mr. AROUGHETI. Yes. I think that is exactly right. And again, one of the things that we have seen over the last decade is that BDCs have grown.

As I mentioned, there are various business models. There are certain BDCs who lend exclusively to venture-backed companies who may be pre-revenue or pre-cash flow. And those will attract a certain amount of de minimis leverage.

And then there are people like ourselves who would probably be moving into lower risk senior secured leverage and attract a different balance sheet profile. So I think that is one of the nice things about the bill.

Mr. NEUGEBAUER. So do you see this, the growing of the BDC market increasing as the—as we see the diminished participation in the banking community?

Mr. AROUGHETI. Yes, I do. I think the growth in the BDC market has been significant, but not nearly enough to keep pace with the growing capital void. So I would hope that this legislation would in fact spur capital formation.

Mr. NEUGEBAUER. And from the panel—these are some thoughtful ideas—are there other things in that space that we need to be thinking about that is under-addressed in this legislation that would encourage the BDC activity and help—more importantly help small businesses access capital?

Mr. Foster, you look like you—

Mr. FOSTER. Thank you. Yes. The first thing that is going to happen, all three of us, our investment grade rated by the S&P, we are the most creditworthy of the BDCs out there.

And the first thing we are likely going to do if the legislation passes is sit down with the rating agencies and talk about their reaction, if any, to it. And they probably won't have a reaction—just because we can have more leverage doesn't mean they are going to allow us to have more leverage. And I don't think any of us are going to take on more leverage if it means a ratings downgrade.

Similarly, like Mr. Arougheti said, we will sit down with our banks and say what, if anything, are you willing to provide us now that we have the ability to have slightly more leverage? And so there is a lot of self-correcting mechanisms, the way we all operate, where you are not going to see a huge amount of immediate leveraging.

You are going to sit down with your constituents. You are going to figure out what makes sense. But I think the shareholders are the winners at the end of the day. And I think that there are businesses out there that we can't reach that we are going to be able to reach. But I think that it will be selective and I think it will take some time.

Mr. NEUGEBAUER. Mr. Quaadman?

Mr. QUAADMAN. Sure, Chairman Neugebauer. Just two points I wanted to make with that.

One is if this bill were to pass, become law, we would see the activity move forward. I think this is also a great example of something that should be taken up by Mr. Hurt's retrospective review bill that was raised in the last hearing, that the SEC can come back in 5 years and take a look at the activity to see if anything needs to be changed, or how BDC activities can be changed more to become a better capital formation facilitator in the marketplace.

The other point I just wanted to raise, too, and this goes back to the last question with the 50 percent cap, my recollection is with the previous bills that were under consideration the last Congress, there was no such cap. So this 50 percent cap in the Mulvaney bill actually provides a low or potentially lower level to financial companies, which I think actually helps operational companies in that regard.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman's time has expired.

The gentleman from California?

Mr. SHERMAN. Thank you.

Mr. Brown, one definition that would be added is for accredited investors or those who have retained or used the services of various advisers. As you understand the legislation, would that mean that an investor could just retain the advice of an adviser who is affiliated with, selected by, or compensated by the issuer?

Mr. BROWN. I don't think there is anything in the legislation that prevents that. It defines categories and all you have to be is in one those categories of people in order to be considered someone who can provide the services that transform you into an accredited investor.

Mr. SHERMAN. So, if I had a product I wanted to get investors in, and let's say I have a perverse interest in selling to those who couldn't even afford the risk, I could just have a CPA or lawyer on staff and say you could advise each investor, and I will pay you to do it. And/or you will earn a commission with regard to the investment.

I don't see any of the other witnesses anxious to contradict that. So I hope we would correct that in the legislation and say that if you are going to be an accredited investor because you have a good adviser, that adviser better not be affiliated with, selected by, or compensated by the issuer. Nor should his or her compensation depend upon whether the investor chooses to make the investment.

We have—back when I was in the business world, which was a long time ago, we established this million-dollar rule; a million dollars now isn't even a good house in many parts of my district. And this $200,000 income used to be those who were really rolling in money.

I would point out that even Members of Congress would be making $200,000 if we hadn't legislated to prevent ourselves from getting cost-of-living increases. And I would hope that we would take a look at this.

If we are going to liberalize the rule by saying well, you are going to get good advice, you don't have to be a millionaire. We would realize in today's world a millionaire is somebody who has at least a couple million bucks.

To say that somebody is a millionaire because they have a net worth of a million ignores the inflation over the last 20 or 30 years. As to leverage for the BDCs, what we have in our economy now is all the money is locked in banks and other very risk-averse investors.

If you want to get a prime loan or a prime plus 1 loan, you can get 10 banks to bid on it. You get all the money and they beg you to take more and you say no. If the U.S.—if the German government wants to borrow money, you have to pay them to take it.

So, those that are—the money is locked up. And if we can get some of that money lent to BDCs and then through BDCs, extend it to the companies that really need it and that are growing and that—or might grow. And then have some risk; that is moving the money from this little sheltered world where it only gets lent to sovereign governments and et cetera and gets out.

Which is why I am a bit reluctant to—I think Mr. Brown commented on this—to see the BDC money then go to financial institutions. It is the financial institutions that already have enough money.

Does anyone here—I will address this to Mr. Foster, but anybody, have any economic analysis that said not as good for investors? And you do have to be here just for your investors. But that it is good for the economy to create another pipeline so that investment money goes to those in the financial sector.

Mr. FOSTER. Sure. Well, yes. We have investments. And Mr. Arougheti has one too. We have—and probably Mike as well. We have investments in leasing companies that might have to occupy a small role in our 30 percent bucket. And would it be nice to not have to worry about that if another leasing company came in because the leasing company's equipment leasing companies, they are helping operating businesses, right. So just because—

Mr. SHERMAN. And in a lot of ways, they are your business.

Mr. FOSTER. Yes. We—

Mr. SHERMAN. They are financing the same people you are financing.

Mr. FOSTER. Yes. But I think our members think that the 30 percent bucket is adequate to deal with those. We welcome it. It would be nice if it were bigger. But I just don't see it as a priority to—

Mr. SHERMAN. Should all financial—

Chairman GARRETT. The gentleman's time—

Mr. SHERMAN. My time has expired.

Chairman GARRETT. Mr. Huizenga is now recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

And actually I will kind of continue on the line of questioning that my friend from California had. And I might add, while I might question your judgment on things on occasion, politically I would view you as a qualified investor. I would hope that reasonably educated people who can go do this would be able to go in and make these types of decisions.

So I am kind of curious about this—sort of this fiduciary issue that seemed to be the pursuit, and about compensation. And Mr. Gerber, when the little exchange was happening you had a very contemplative look on your face. I am curious if you were looking to try to respond to that or any of the others.

And then Mr. Quaadman, you had mentioned that from your perspective, quickly, at the end of I think it was Mr. Neugebauer's questioning about you believe that this could help operational companies. And I wanted to expand on that a little bit.

And then Mr. Arougheti, you had talked a little bit about adequate protection. So that is kind of that direction I would like to go.

And Mr. Gerber, I don't know if you care to lead off, if you had something to say about that fiduciary element?

Mr. GERBER. I am not sure exactly which period of the discussion you are referencing. But I think what—

Mr. HUIZENGA. I think it was like the time of compensation for someone who was giving advice, where that compensation would come from.

Mr. GERBER. Yes. The thought that was crossing my mind at the time, because there are some related issues between these two bills, and the gentleman from California was asking questions about conflicts of interest. And that has come up with some of the provisions in the BDC legislation as well where there could theoretically be an adviser-issuer conflict.

And that is something that Congressman Mulvaney has tried to address in the BDC legislation by ensuring that the SEC would have an opportunity to review those types of conflicts. And I think that is an improvement over the legislation, the BDC legislation.

And again, it is not a priority for Franklin Square, but it is something that we think is important to consider on behalf of the industry and on behalf of investors in the BDC industry. And we were pleased to see that addressed in Mr. Mulvaney's draft legislation.

Mr. QUAADMAN. Sure. Chairman Huizenga, the point I was trying to make is in the previous BDC legislation that was considered in the last Congress, there was no such 50 percent cap on financial companies. So, theoretically, a lot more than just 50 percent could have gone in.

The current draft actually provides a ceiling. So theoretically, with that ceiling you would have a certain amount that would have to go to operational companies.

Frankly, if you take a look at the BDC model historically, they are going to be investing in operational companies anyway. But I think this creates a ceiling where there hadn't been one before.

Mr. HUIZENGA. And the vast majority of your investments, right, the gentleman that actually are involved in the BDCs here, they do go into operational companies. Correct?

Mr. GERBER. Absolutely.

Mr. QUAADMAN. Okay. Mr. Arougheti, you had the microphone there for a second. Why don't you talk a little bit about the adequate protections that you thought were in there for those investors? And that seems to go back a little bit ago, so I don't know if you remember uttering that, but I do—

Mr. AROUGHETI. Yes. It is interesting because I think people have been focused appropriately on regulation and shareholder protection.

I will just reiterate some of the things that Mr. Gerber said in his testimony that as far as financial services models go, you can't get more transparent than a BDC.

We have a quarterly schedule of investments where we delineate every investment in the portfolio. If you juxtapose that with a bank balance sheet, as an example, it would be very difficult for anybody in this room to actually open up a public filing for a bank and figure out exactly what they own.

Now, they are under a completely different regulatory regime, so that is not to say that they are bad investments. But I think it is important that we always get re-grounded in the transparency and the regulatory framework under which we operate.

Vis-a-vis the increase in leverage, a very positive change in the new legislation being introduced is this idea of shareholder protection through a cooling-off period.

I personally believe that the investor community will welcome this change and it will actually create a significant amount of renewed interest in the BDC space from both retail and institutional investors.

But the idea of giving the retail investor the opportunity over a prolonged period of time to vote with their feet I think is a very innovative way to give them the adequate protection that certain people are trying to give them.

Mr. HUIZENGA. Okay. Any concerns, anybody, about whether there might be leveraged money allowed to be leveraged again in this if you were changing that ratio? That had been—someone had brought up to me that sometimes these investors into the BDCs are using leveraged money.

So my time has expired. But thank you.

Chairman GARRETT. Thank you.

Mr. Hinojosa is now recognized for 5 minutes.

Mr. HINOJOSA. Thank you, Chairman Garrett. And thank you, Ranking Member Maloney, for holding this hearing.

It seems to me that when it comes to innovation the United States is the envy of the world. And we are the envy not only because our economy values and rewards entrepreneurship and hard work, but because our markets are transparent, safe, and liquid.

My first question goes to Professor Brown. The discussion draft of the Small Business Credit Availability Act creates multiple classes of preferred stock, each with different shareholder rights. With different characteristics and rights, do the new classes of preferred stock pose risk to retail investors?

Mr. BROWN. I think that there are advantages to multiple classes of preferred stock. And of course operating companies today have that authority.

I think that this draft legislation eliminates some investor protections that are associated with preferred shares. And I think that is of concern. I think the idea that this legislation would limit the purchase of those shares to qualified institutional buyers is a helpful way to approach that.

My concern is actually not with the purchase of preferred shareholders, but the common shareholders. This bill would strip away the obligation to have voting rights on those shares. But it would also allow for things like super-voting stock, at least as I read the legislation.

There is no legislation of voting rights anymore if this bill passes as is. So in theory, a board of directors could transfer voting rights away from the common stockholders and to the preferred shareholders.

I actually have a suggestion in my testimony as a way that I think that should be fixed. I don't think that authority should be allowed.

Mr. HINOJOSA. Mr. Brown, as you know, H.R. 2187 would classify brokers, investment advisers, accountants, and lawyers as accredited investors. The legislation assumes that these persons or entities by nature of their profession are sophisticated enough to understand the private securities offerings under Regulation D. Do you have any concerns for these classes of persons being deemed sophisticated under the law?

Mr. BROWN. Congressman, I sure do. And as I mentioned in my testimony, I know lawyers, obviously the best. I teach them. I am around them all the time. They are not an inherently sophisticated group of people, at least when it comes to investments.

The education—we have plenty of lawyers in this room. In your law school education, you are not taught about the intricacies of complex investments. We are lucky if students take corporations or securities at all. And then those courses don't really prepare you.

So unfortunately, the way this is drafted right now it doesn't take into account age. It doesn't take into account experience. And really you can't really rely on education as a way of saying that they are sophisticated. So I am concerned about those categories.

Mr. HINOJOSA. Thank you.

My next question is to Vincent Foster.

Pursuant to Section 413 of Dodd-Frank, the SEC is currently working on a study of whether it needs to redefine its current accredited investor definition. Rather than jumping in with a legislative fix, do you think we should wait to see how the SEC comes out on any changes to the definition?

Mr. FOSTER. I don't think the SBIA really has a position on that because we are dealing exclusively with either SBIC funds that have as their investors accredited investors, or SEC-registered companies that have as their investors retail and institutional shareholders, which is accompanies by extensive disclosure and generally full liquidity for the shares. And so I don't think we really have a position on that.

Mr. HINOJOSA. Okay.

Next question is for Mr. Arougheti. In your testimony you have indicated that commercial banks and other traditional financing sources continue to retrench the business of providing loans to small and medium-sized companies. Can you elaborate on your prepared testimony and provide us some insights into why you think this retrenchment is happening? And what, if anything should be done to ensure that those small and medium-sized businesses have adequate access to capital?

Mr. AROUGHETI. Sure. I will try to be brief. It looks like we are pressed for time. But I think it is important to put this in historical—I'm sorry, Mr. Chairman. Should I—?

Chairman GARRETT. You can finish.

Mr. AROUGHETI. To put it in a historical context, because the shift from banks to nonbanks, or what we would call parallel banks, has actually been occurring for about 25 years. And it started in the late 1980s with a big wave of bank consolidation in this country.

So I just think it is important that we clear the misperception that this is a post-Great Recession issue. This has been happening in this country for 25 or 30 years. I think it has accelerated post the Great Recession for a whole host of market-based and regulatory reasons. But I don't think there is any one issue.

I think something that has gotten some discussion is also just talent. I think a lot of the folks like ourselves who are classically trained within bank credit programs have frankly fled the banking industry and now reside in firms like BDCs. And I think that is part of it.

Mr. HINOJOSA. Thank you. I yield back.

Chairman GARRETT. Thank you.

Mr. Stivers, you are recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you holding this hearing on this very important issue of access to capital and capital formation in our economy. And as the Chair of the Middle Markets Caucus, I know how important middle-market companies are, not only in Ohio, but throughout our country.

They represent about 200,000 businesses, about a third of our economy. They employ 47 million Americans, and BDC loans in that middle-market marketplace have tripled, in fact, over the last—since 2008, I believe, so a lot of money. Currently BDCs net about, I think, and somebody can correct me if I am wrong about this, $70 billion of outstanding middle-market loans.

So my first question is for Mr. Arougheti. Can you please help this committee and everybody understand how this bill would help impact capital access to these very important middle-market firms by allowing BDCs to have greater access to capital and leverage?

Mr. AROUGHETI. Sure. I think a real-life example, but just to understand why BDCs are so attractive as capital providers. We are permanent capital vehicles. So we have many of our portfolio companies who view us as their bank, their lender of choice. And we try to service them throughout their entire lifecycle.

So we have 250 portfolio companies, a number of whom we have been lending to for 10-plus years in a whole variety of different ways. It all comes down to scale and product capability.

And the broader our product set, i.e., if we can service those same clients and customers with senior secured asset based loans that currently don't meet the economic requirements of the BDC, that will be a good thing for those underlying companies.

To the extent that the banks can provide some of that marginal credit, I think that is a good thing as well, because that just promotes more competition and more healthy cost of capital to the investors. But I think it is really about the increasing mandate that the asset coverage test would provide us.

Mr. STIVERS. I appreciate that. And clearly BDCs add value to the economy, are adding a lot of value to these middle-market companies that are in many cases family-owned, and in a lot of cases fast-growing and employing as I said 47 million Americans. So I want to thank all of you for your willingness to do that.

I do want to quickly hit on transparency and protections because I think that is important. With regard to transparency, I think, Mr. Gerber, you said it really well when you talked through the quarterly reports you have to do where you do a whole review of your portfolio by company, by amount. No bank does that. No other financial institution in the capital markets has that kind of transparency, do they?

Mr. GERBER. That is right, Congressman. And I think that is one of the reasons why we are all very comfortable making the recommendations we are making. It is because of the power of the transparency behind the model of the BDC.

And you are right. When you compare us to other lenders, even if we were to go to 2-to-1 leverage, it would still be far less leverage.

And I think Mr. Arougheti addressed this in his comments, far less leverage than the other lenders against which we compete. And I mentioned it earlier as well. Banks are anywhere from 8-to 15-to-1. Hedge funds are in the mid-teens. We are just talking about 2-to-1. But it is 2-to-1 in a far more transparent model.

So as Mr. Arougheti said, you cannot go to a bank's balance sheet or filing and find a schedule of investments like you can in a BDC. And we all know you certainly can't do that in a private fund, whether it is a private credit fund or a hedge fund that is engaging in lending.

So it is the most transparent form of lending in the marketplace. And we are—even if we go to 2-to-1, it is one of the lowest levels of leverage.

Mr. STIVERS. And I would like to just give you a second to expand upon that because today you are absolutely the lowest leverage at zero. But if you went to 2-to-1 leverage, that would be between 4 and 10 times less leverage than your competitors in the marketplace employ.

Mr. GERBER. That is right.

Mr. STIVERS. Thank you.

And the last thing I do want to hit on is protections with regard to accredited investors. We all did laugh at the lawyer joke. And I think we should cut all their bills by about 50 percent because of how unsophisticated they are.

But I do think that—I was in the investment adviser business. If you pass a Series 7, you are pretty sophisticated, I would argue. If you pass—my sister is an accountant and their exams are really hard. You are pretty sophisticated if you are an accountant.

We can all debate the attorneys, I will give you that. But clearly most people in those professional educations are way more sophisticated than just being worth a million dollars—would you say that makes somebody more sophisticated than just being worth $1 million, regardless of how they got it, Mr. Gerber?

Mr. GERBER. I don't consider myself an expert on this one—

Mr. STIVERS. Okay.

Mr. GERBER. —Congressman.

But what I would like to say to you is that when you just look at arbitrary numbers, I don't think you are getting into a substantive consideration. And I think the proposal before us is driving at the notion that we ought to be considering something other than just arbitrary numbers.

And I don't know that anybody on this panel would disagree that sometimes the substance of someone's background may be more meaningful in terms of their level of sophistication than just the assets that they have in their possession.

Mr. STIVERS. Thank you.

Thank you all. I am out of time. I yield back the balance of my time. But thanks for being here.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Massachusetts, Mr. Lynch, is recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. And I want to thank the members of the panel. You have been helpful.

Let's drill down on that a little bit, though. Under the terms of the bill right now, H.R. 2187, a personal injury attorney with no other requirements would be able to self-certify as an accredited investor. Isn't that right, Mr. Quaadman?

Mr. QUAADMAN. I believe you are correct, and that is one of the reasons why we said there should be an SEC study to see exactly what those characteristics are.

Mr. LYNCH. Right.

Mr. QUAADMAN. So we think Mr. Schweikert is going down the right path. But maybe it is also good to have the SEC look at it and then report back as to what some of those substantive different changes should be.

Mr. LYNCH. Right. I totally agree.

And I think for the CPA side of this, someone who does your taxes once a year doesn't necessarily know what we are talking about in many cases—27 of these BDCs are private, they are non-traded. So they are rather opaque investments.

And I don't think the average tax attorney or personal injury attorney, excuse me, would necessarily be able to drill down and make a good determination whether or not that investment is right for themselves or for others.

The bill also says that as long as you hire a registered broker-dealer, that allows you to make that investment as well in a BDC that might not have the information public. Mr. Brown, does that create a problem?

Mr. BROWN. I certainly believe that it does.

If we go back to my 85-year-old parent or uncle or friend, and we were to say if they happen to have a lawyer who maybe was their estate planner or a CPA, as you say, who was doing their tax returns, and those two people gave them some investment advice, is that person really suddenly transformed into someone who is sophisticated just by virtue of the relationship? Not necessarily.

Mr. LYNCH. Okay. I want to ask you something else.

Professor Brown, as you are aware, Congress passed and the regulators have finalized the Volcker Rule to prohibit banks from using their taxpayer-backed deposits to make proprietary trades. The final rule accomplished this by requiring banks to divest from certain assets.

However, BDC funds were excluded from that definition. And for purposes of defining affiliation as well, BDCs were not considered to be affiliated with a bank so long as the bank's ownership of the fund was under 25 percent.

Recently, Goldman Sachs took a BDC public. They retained a 20 percent share in the company. Credit Suisse has also formed a BDC. I am not sure what their retention is. Should we be concerned now that even before the Volcker Rule is effective we are already tinkering with an asset class that may enable banks to re-engage in proprietary trading?

Mr. BROWN. I can say that it concerns me. And my concern is—there are a couple of them. But one of the ones is that banks, when they form these other entities, especially when it is the big commercial banks, the market just judges them differently.

Sometimes the market thinks that the big bank is making an implicit guarantee of backing that company even if they only own less than 25 percent.

Mr. LYNCH. Right.

Mr. BROWN. That other company gets a break on—the company can borrow at a cheaper rate. I might be able to do things that other BDCs can't do. So I worry very much when banks get into space like this that it may dramatically change the nature of that market. And it frankly may give them a competitive edge that other BDCs don't have.

Mr. LYNCH. Okay. Thank you very much.

Mr. Chairman, I yield back.

Chairman GARRETT. Thank you. The gentleman yields back.

The gentleman from Arizona, Mr. Schweikert, the author of the legislation before us today, is now recognized.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. And we will walk through a couple of the things, and maybe if one or two of the misunderstandings and then work through—work a little backwards from there.

First of all, I think for all of us here there is an understanding that we have both the societal problem and some other mechanical problems. My understanding is that of our 318 million population right now we have only about 600,000 Americans who have gone through the process who are qualified investors.

We know that half of our Baby Boom population is moving into retirement with very, very little savings. So part of our goal here is how do we move more of our population into the investment class, and do it in a safe and rational fashion? And so I actually have been working on this bill for a while, but quite open to any brilliant suggestion.

I do want to go over a couple of things, just because one I think was sort of a misunderstanding, a misstatement. Under current legislation right now, under a current law 506, if you are the lawyer, if you are the CPA, if you are the registered broker-dealer, you get to certify someone as being a qualified investor. It doesn't make you a qualified investor.

The second part of that is the way the bill is drafted right now, if you were to hire one of those people for guidance, it would allow you to invest in some of these products. Maybe that is where it needs to be tightened up.

And my first question, Mr. Chairman, and it was actually to Mr. Brown, just one quick one. You are actually on the SEC's committee that has been somewhat looking at the definitions of qualified investor?

Mr. BROWN. Yes, sir, I am.

Mr. SCHWEIKERT. Would I be pushing the limit of getting too complicated and too, I will use the word "sophisticated," to also look at it as saying a 30-year-old who just happened to do really well that year who has $50,000 of risk capital is a lot different than your 80-year-old mother example?

Would you be also willing to support an idea that also would put some time as part of one of the kind of counterbalancing—or age as one of the counterbalancing factors?

Mr. BROWN. Absolutely. And when I read your draft, there is no question in my mind that was a good-faith effort to try to address a problem that the Investor Advisory Committee agrees is there, which is how to let people who are sophisticated in fact, actually sophisticated, irrespective of the dollar amounts, to invest. The definition should allow for that.

We are in complete agreement. I should say I am, but the committee's recommendation.

I do think, for example in the testing area, in your language in the bill I think there should be a provision in that says the test only lasts for so long. I think if somebody is 30 and then they—I don't want them to have taken it once and then at 80, that is fine. There should be some—

Mr. SCHWEIKERT. But for those of us who do really well on multiple guess tests, we like that.

Mr. Quaadman, what would you suggest in the world of—is it a—would you be comfortable with a world where a broker-dealer could provide advice to someone to invest in what today is limited to only qualified investors? And if not, how would you tighten it up? What would make you comfortable?

Mr. QUAADMAN. My concern there is you could take an unsophisticated investor and effectively use the accredited investor patina of the broker-dealer and then transfer it over to that unsophisticated investor. And that is why I think there are some issues where, even though there is advice that has been given, the unsophisticated investor, just by definition, may not necessarily understand the risks that are involved.

Mr. SCHWEIKERT. If we created sort of an A-B test in the legislation, something that also demonstrates some risk capital or something of that nature, would that create a—

Mr. QUAADMAN. Yes, and that is where I think we need to get to is that you need to ensure that the investor has a level of knowledge where they can understand what the risks are that they are undertaking. And then you also want to have something else underneath to make sure that the risks that they are taking are commensurate with their financial experience.

And you can take the flipside too, because if you take a look at the bright line test, right, what is interesting there—because I talked to somebody who was at the SEC in 1982. They picked those tests because they couldn't really figure anything else out at the time.

Mr. SCHWEIKERT. Mr. Chairman, in the last 30 seconds, and I think all of us have come across this experience, I have a very good friend, P.H. Dean Electrical Engineering had some friends that had started a business. He is an absolute international expert in this subject, except he wasn't allowed to invest in it.

How do we reward people, both from their risk tolerance, where they are in their lifecycle of investing, but also their knowledge base, and get rid of the sort of arbitrary that you have made it in like—you get to continue to make it in life. Because you are on this side of the ledger, you don't get to participate. We are quite open to any brilliant ideas that will come our way.

With that, I yield back, Mr. Chairman.

Chairman GARRETT. The gentleman yields back. I am looking forward to more brilliance from Arizona on the legislation then.

We now go to Connecticut. And Mr. Himes is recognized for 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman.

And I thank you all for being here for the duration. I am encouraged by what is a robust and substantive bipartisan conversation.

I do have, though, a couple of—and by the way I appreciate Mr. Mulvaney's offer. I have a couple of concerns that I would like to have addressed here. The first and most important pertains to the levels of leverage that would be permitted under the Mulvaney proposal.

Specifically if you start to do the math on the 30 percent bucket where, as you know, there are plenty of firms out there that are holding equity tranches in CLOs which themselves are seven, eight, nine, 10 times levered.

When you start to do the math on going to 2-to-1 leverage in these instruments, on investments in financial companies which may themselves have 3 or 4 times leverage, investing in instruments which themselves may have 7, 8, 9 times leverage, you pretty quickly get to some pretty stratospheric leverage numbers. It is not hard to get up into the sort of 70x leverage numbers if you just work through that math.

And of course if you then expand the 30 percent bucket into 50 percent, you have conceivably, and I understand that there will be some prudence exercised by some players in the industry, but you potentially have a very highly leveraged vehicle here.

So I wonder—and let me just start with Mr. Gerber since he is in the business. And then I would welcome comments. But am I right to be concerned that if we permit this degree of leverage, you have essentially a very, very volatile instrument?

I don't need to tell you that at 50x leverage, a tiny fluctuation in the value of underlying asset puts this instrument completely underwater and eliminates the investment of a lot of retail investors for whom this product is created. So, Mr. Gerber, make me feel more comfortable on that issue.

Mr. GERBER. I will make my best effort. I think in the question you are raising, there are really two issues that are distinct, but at the same time, when brought together you have to consider it as a whole. So on one hand, it is increasing leverage going from 1-to-1 to 2-to-1 in our debt-to-equity ratio.

On the other hand, it is the redefinition of an eligible portfolio company, moving something out of the 30 percent basket that we talk about into the 70 percent basket. And I think what you are getting at is if you combine the two, what is happening to a term that we all are familiar with, effective leverage.

You are looking at three of the BDCs in the space that have lowest levels of effective leverage. And you can—different people have different ways of defining effective leverage and doing different calculations. And I think when you look at any lender, whether you are looking at a hedge fund or you are looking at a bank, you have to ask the same questions.

And so what you are essentially looking at is the multiplier effect, if you will. And in our—

Mr. HIMES. Well, that is the math I was doing. And again, I get that you guys are prudent, but—

Mr. GERBER. Yes. But if I may just finish—

Mr. HIMES. On the less prudent side—I want to check my math first.

Mr. GERBER. Yes.

Mr. HIMES. Again, you could very quickly see very high degrees of leverage in this instrument.

Mr. GERBER. Yes. I think so. And that is why you hear some expressions of concern up here at the panel. And I think that is one of the areas of legislation where we still have some more work to do as an industry. And the members of the committee, and I think we are all committed to doing that work together.

But what I wanted to mention is earlier when Mr. Arougheti was talking—and I referenced this concept as well about—would all of the BDCs be able to access more leverage, and the answer is no, they won't. And they won't whether it is because of the rating agencies that Mr. Foster talked about.

They won't because of the covenants that the banks require—I'm sorry, the regulators require the banks to have in their loans to us. They won't because the analyst community and the investor community is going to look at the substance of those portfolios.

And so if you see mission creep, if you will, or if you see growth in the overall BDC in fin co investments, you are going to see downgraded ratings. You are going to see BDCs potentially violating existing covenants.

So there are these natural governors in place. And I think as we work through this language and think about the full impact of it, we have to keep in mind those natural governors that are in the system.

Mr. HIMES. Could the industry—and I don't have a lot of time—live with a modification whereby those investments in companies—in the small businesses for which this instrument was created, were allowed to lever 2-to-1 as is proposed, but in the 30 percent bucket or in the financial bucket, the 1-to-1 ratio obtained. Is that a reasonable proposal?

Mr. GERBER. Yes. I think we have heard that. I think it would be somewhat complicated to sparse it out like that, money is fungible. So I think in effect what you really would be saying is instead of going to 2-to-1, you are going to 1.75 and 1, or something along those lines. But whether or not there is a practical way to ensure that any increase in leverage isn't being applied to some subset of investments, I think would be somewhat difficult.

Chairman GARRETT. Thank you.

Mr. HIMES. Thank you. Thank you, Mr. Chairman.

Chairman GARRETT. Mr. Poliquin is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman, very much. I appreciate it.

And thank you gentlemen for all coming today. If we all as a country look at the state of our economy, where it has gone and where it is going, in the last 5 or 10 years, my understanding is that about 80 percent of the new job hires in this country were in the small-to medium-sized business space. So we want to make sure that we do everything humanly possible to help our small businesses grow.

I just looked at a survey a short time ago saying something like 42 percent of business executives believe that the lack of financing is one of the key reasons that they just don't have the confidence to hire more workers and grow their business.

So I know that Dodd-Frank is a smothering regulation that is reducing the available credit among lots of players in your space. And so I salute you folks for trying to fill that void.

I just heard something, Mr. Gerber, a short time ago that I want to drill down with you a little bit if I may, something that for a non-traded BDC like you folks that the information that is provided tends to be opaque. Now, we want to make sure that investors who are investing in these sort of financial products, that they have all the information they need to go forward. Could you address that, sir?

Mr. GERBER. Sure. Thank you, Congressman.

It is often a misconception with non-traded because when you hear the term non-traded, it just sounds different. But non-traded BDCs follow all the same regulatory processes and procedures as traded BDCs.

So, non-traded BDCs are in the 1933 Act, the 1934 Act, and the 1940 Act. We have all the same public disclosures as traded BDCs. At Franklin Square we manage both traded and non-traded BDCs. And we manage more non-traded BDCs than any other manager. And I can just tell you the hours that our legal staff and accounting folks put into those filings is significant.

But just because we are non-traded does not mean we are opaque. It does not mean that we are not providing the same level of disclosure that traded BDCs provide. We absolutely do.

Mr. POLIQUIN. Okay. So contrary to what was said here today by a member of this committee is that an investor will have the same type and same amount and detailed information if I am buying a traded or non-traded BDC, is that correct, sir?

Mr. GERBER. That is, and actually more. And let me explain to you why. Because when a firm like Franklin Square distributes a non-traded BDC, we also fall under FINRA and blue sky regulations.

So, all 50 States are regulating our products. We are filing in all 50 States. We have to meet the suitability standards in all 50 States. The advisers and brokers that put their clients in our funds have to get a wet signature from their clients, our investors.

So the reality is the non-traded investor probably has more opportunity to understand the investment than even an investor in our traded BDC. So it is I would say even heightened for the non-traded investor—more disclosure, more transparency.

Mr. POLIQUIN. Thank you for clarifying that, Mr. Gerber. I appreciate it very much.

Mr. GERBER. Thank you.

Mr. POLIQUIN. You bet.

Now, I want to pivot a little bit here. And we only have a couple of minutes left. I will start with you, Mr. Arougheti.

You folks, and all you folks in the financial industry space live under this net, this Dodd-Frank net, which was intended for a small number of money center banks that really have tentacles throughout our economy that could cause a problem if something happens, but are certainly not designed for everybody.

I want to know if you could wave a wand, what one regulation now within the Dodd-Frank net would be best to remove, repeal, or reform such that you folks are able to grow your portfolio companies and hire more workers?

Mr. AROUGHETI. Yes. I will answer.

We are not Dodd-Frank-regulated, so for us we are not focused on Dodd-Frank. As we have said numerous times, we are heavily regulated under the 1933 Act, the 1934 Act, and the 1940 Act. I think Representative Mulvaney has done a wonderful job putting forward legislation that would actually advance the industry.

Mr. POLIQUIN. What about you folks possibly being regulated by the DOL or by the Federal Reserve or the SEC? How does that make you feel?

Mr. AROUGHETI. It comes with a different set of regulations and a different set of opportunities. So as I highlighted earlier, if we were a bank and we were levered 10-to 15-to-1 and we took depositor money we would be subject to a separate set of regulations versus the 1940 Act closed-end fund who is taking retail and institutional investments.

So again, I, for better or worse haven't put myself in that theoretical construct. We are focused on the regulatory regime that we are subject to.

Mr. POLIQUIN. Okay.

Mr. Foster, do you want to add anything to that?

Mr. FOSTER. Sure. I asked our lead investment bank Raymond James if the DOL rule that is about to come out would impact them because a lot of our shareholder are individuals but they invest through IRAs and 401(k)s. And they canvassed their system and did not think it would be significant. But you think it could be.

Mr. POLIQUIN. Thank you.

Mr. Quaadman, would you like to respond in my waning seconds here?

Mr. QUAADMAN. Yes. Just to—investment advisers are extremely concerned about the fiduciary duty role that it is going to have a very significant impact on their ability to invest.

In fact, we issued a study last week that 9 million small businesses in the United States are going to be prevented or severely crimped in their ability to provide retirement vehicles for their employees if that rule goes through.

Mr. POLIQUIN. Thank you, Mr. Chairman, for the additional time. I yield back. Thank you.

Chairman GARRETT. Thank you. The gentleman yields back.

Mr. Carney is recognized for 5 minutes.

Mr. CARNEY. Thank you, Mr. Chairman, and Ranking Member Maloney for holding this hearing today. And thank you to Mr. Mulvaney and Mr. Schweikert for these proposals.

I would like to—I have to admit I don't know a lot about BDCs. And so I found your testimony very interesting. And I just have really two questions.

One is to you, Mr. Foster. On page five, I would like to understand a little bit about how these BDCs are operating in my area. I am the Representative from the State of Delaware, the whole State, which is a very small place.

But I notice on here that it has a pretty big number under it on your map on page five, particularly relative to States that are much, much larger. Can you explain that? Is that a function of our fact that we are the State to incorporate your business? Does that have anything to do with that? Or is that a function of greater BDC activity in my State?

Mr. FOSTER. I can't really explain why there is—I guess it says a billion five—

Mr. CARNEY. Yes. We are doing better than New Jersey—

Mr. FOSTER. Oh yes.

Mr. CARNEY. —Connecticut and Maryland, just about.

Mr. FOSTER. Maybe one of the two Michaels—

Mr. CARNEY. Anybody else? Mr. Gerber, you are from our region, right?

Mr. GERBER. Yes. I think what Mr. Foster wanted to say is it is the excellent representation in Congress that is driving the heavy investment—

Mr. CARNEY. All right.

Mr. GERBER. I think you hit the nail on the head.

Mr. CARNEY. Flattery will get you everywhere.

Mr. GERBER. At Franklin Square we have a portfolio company, it is U.S. coatings acquisition. I do think it is in part because of the corporate laws in Delaware and the number of firms that are headquartered there—

Mr. CARNEY. It is more a question that these are domiciled in some kind of way.

Mr. GERBER. I think that is exactly right. Now in our case, our investment has more to do with just the work that is done at the portfolio company. But I think the phenomenon you referenced is—

Mr. CARNEY. Can you—obviously you are located in our region. Is most of your activity in the region?

Mr. GERBER. No. As I mentioned, sir, earlier in my testimony, we have deployed capital in 39 of the 50 States. And between the 3 of us, our entire industry, we have invested in companies in all 50 States. I think it probably depends on the scale of the BDC. In our case we have the largest platform. We have national reach. So we are sourcing deals all over the country.

Mr. CARNEY. I think this is a pretty reasonable approach to updating regulations from BDCs. I do share Mr. Himes' concern about the leverage question.

So I would like to kind of follow up where he left off, which was, is there a way—Mr. Gerber, you started to respond to how you might consider addressing that concern. Would you like to follow up on that, or Mr. Arougheti, or Mr. Foster, would you like to address that?

Mr. AROUGHETI. I will make a couple of comments.

Mr. CARNEY. Please.

Mr. AROUGHETI. And it harkens back to some of my earlier comments—

Mr. CARNEY. It just gives us a little heartburn.

Mr. AROUGHETI. Yes. I think anybody here would struggle to actually get leverage on the types of investments that you are expressing concern over.

So first and foremost, the draft legislation, as I read it, excludes CLOs. And Representative Himes—

Mr. CARNEY. He mentioned that.

Mr. AROUGHETI. —mentioned CLOs. That is excluded.

However, Ares is actually one of the larger CLO managers in the broadly syndicated market. And getting leverage on a CLO equity investment is not possible in the market. So it goes back to some of the natural governors that exist in both the banking sector and the investment grade bond sector that regulate what can and can't be leveraged.

So if we put together a portfolio that was 50 percent CLO equity, even though it is excluded, but for arguments sake, if we did and we took that portfolio to the rating agencies and the bank, we would not have an investment grade rating and we would not be able to get a loan on it. So—

Mr. CARNEY. There are market-based controls on that, is that what you are saying?

Mr. AROUGHETI. Yes. Market-based, bank and capital markets.

Mr. MULVANEY. Will the gentleman yield for a second?

Mr. CARNEY. Sure. Absolutely.

Mr. MULVANEY. Very briefly, and I appreciate the question, just because I was hoping to get to this while Mr. Himes was still here. But the draft legislation specifically excludes investments in CLOs, hedge funds, and private equity. So some of the examples he gave would not have been permitted under the draft legislation.

Mr. CARNEY. Great. Anybody else?

Mr. FOSTER. I will add, I think it is—we have given some thought to it. I think it is theoretically attractive to provide the 1-to-1 to the 70, but not the 30. But if the 30 gets bigger, then the bill begins to lose its effectiveness.

And I do—I am concerned because most of us are on—all of us are owned primarily retail investors. And they get 1-to-1 or they get 2-to-1. But when you start explaining the baskets and how we are going to report that to them and how we are going to monitor it, and what it does to this, I don't think it is a practical solution.

Mr. CARNEY. So maybe what we could do is get some feedback to those Members who have concerns. I am looking at the sponsor just to give us some level of comfort. That is great.

I yield back. Thank you.

Chairman GARRETT. Thank you. Thank you, gentlemen.

It looks like our last two questioners are Mr. Hultgren and then Mr. Mulvaney. And then we vote, I think.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here.

Chairman GARRETT. But not on your bill. You looked as if we are ready to vote on your bill, but no, on the Floor.

Mr. MULVANEY. I thought you could pull some strings, Mr. Chairman. I usually look at you in a confused fashion most of the time—that is nothing new.

Chairman GARRETT. That is kind of a normal look.

Mr. HULTGREN. Thank you all. I appreciate you being here. I do want to thank all of you for your input and the work that you are doing.

Thanks, Mr. Gerber, for your clarification too. I think there were some inaccuracies that I had heard in some statements on the other side with some of the non-traded BDCs, and some statements that those were less than transparent. And I really appreciate you clearing that up, that there is an incredible amount of transparency and accountability available there. And that was very helpful.

I want to shift gears just a little bit if that is all right. And I think I will address this first one to Mr. Gerber, but then also, Mr. Foster and Mr. Quaadman, I would appreciate your thoughts on this as well, and maybe Mr. Arougheti, as well.

But I have heard a great deal about access to capital, and its role in creating jobs. I wonder, could you tell me a little bit more about the reality of how your business, Mr. Gerber, helps with job creation in the middle-market?

Mr. GERBER. Sure. In its really most basic form companies are coming to us, looking to grow or looking to stay in business and in need of capital. And when we provide that capital, and as Mr. Arougheti explained, sometimes because of the permanent nature of our funds we can be long-term partners and provide managerial assistance to these firms.

We are helping them stay in business and we are helping them grow. And it does have a direct impact on jobs. In your State, Congressman, Franklin Square alone has 10 portfolio companies. We have deployed over $380 million. And to firms that represent over 33,000 jobs.

Across our entire portfolio we have invested in over 300 companies, representing more than a million jobs. And you heard earlier in our testimony and some of the comments from some of the members of the subcommittee, we are lending primarily to small middle-market all the way up to large middle-market firms.

And they now represent a third of the private sector workforce. So there is a direct correlation between the work that we do in deploying capital and the growth of the middle-market and the job creation in the middle-market.

Mr. HULTGREN. That is fantastic. I appreciate it. The number one thing we continue to talk about is job creation and how do we get this economy growing, and growing more quickly. And so that is great news, especially for my State of Illinois. We are looking for good news, so it is nice to hear about jobs being created there.

Mr. Quaadman, any thoughts from your membership on what you are hearing as far as access to capital, and specifically this tool that really is potentially beneficial on both ends, certainly from the investor side but also from the recipient of access to capital?

Mr. QUAADMAN. Yes. We are seeing very severe problems in terms of access to capital, primarily with small businesses and larger businesses. Part of it is the slow implementation of Basel III, which is slowly drying up bank loans. But we are also going to see if total loss absorbency coverage goes through in 2019.

That is actually going to siphon hundreds of billions of dollars of capital out of the global markets. So what we are seeing is we are seeing this slow combination of events happening where logically, each of these different regulatory initiatives would make sense by themselves.

When you put them together, they have very dramatic impacts. And what we have seen, and this is a Census Department report I had mentioned, I think in April, that we are seeing a net destruction of firms in the United States over the last 6 years.

So we are not seeing the smaller firms being created at the same rate that we used to. So the BDC legislation is good that we are helping the middle-market companies and the like. So, but we need to help the smaller guys as well.

Mr. HULTGREN. Yes. And it is something that is really part of my heartbeat is I just believe so strongly that really the foundation of this country is the ability for someone to have an idea, be passionate about it, have some gifts and talents that they want to put into this, but also to have partners that could come alongside where they can get access to capital to turn that into truly the American dream. We talk about that, but this is the reality.

But so, Mr. Foster and Mr. Arougheti, any other thoughts on this as far as job creation with this—

Mr. AROUGHETI. I think one additional comment which I don't think we have mentioned before is that by regulations, BDCs are actually required to provide managerial assistance to their portfolio companies, which is often overlooked, but also contributes to the strategic value that we add to middle-market companies.

So to put that in perspective, within Ares Capital Corporation we sit in on, or sit on the boards of directors of over half of our portfolio companies. So our portfolio companies look at us as their bank or their lender of choice. But I think they also look at us as a strategic adviser as they grow their business.

Mr. HULTGREN. That is great I don't think that was something that I understood fully: the value that could come from that, and learning from other companies that are succeeding. Quite honestly, learning from successes and failures can be certainly beneficial to these small and medium-sized companies, as well.

Mr. Foster, any last thoughts?

Mr. FOSTER. Sure. And a good example is we specialize in change control transaction with retired business owners. The kids aren't in the business, they are too small for a public company to buy, too small for private equity.

We will come in there and arrange a change control transaction. And then in the last 10 years prior to retirement, the last thing they want to do is open up a new plant. So very frequently we are able to come in and regain a growth trajectory. And if it wasn't for us, not only are you creating jobs you might not even retain those jobs.

Mr. HULTGREN. My time has expired. Thank you all very much.

Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. Thank you. And to have the last word, Mr. Mulvaney, the sponsor of the underlying legislation.

Mr. MULVANEY. Thanks, Mr. Chairman. Thanks as well to Mrs. Maloney for the work she has done on this bill with me, along with a couple other Members.

And thank you, Mr. Carney, for sticking around because I want to address a couple of housekeeping things.

First, Mr. Chairman, I have a statement from Prospect Capital Corporation, which is a BDC that has done business in my district. And they would like to enter a statement into the record. So I would like to do that without objection if I may, please.

Chairman GARRETT. Without objection, it is so ordered.

Mr. MULVANEY. Thank you.

Mr. Carney, we talked before and I think we addressed some of that stuff about specifically excluding it. But we will continue to talk. But one of the things I will point out when we have these discussion is that while everybody gets a little bit nervous every time we talk about levering up or increasing anybody's leverage, I direct your attention to the screen. Even with the proposed changes, this is still going to be the least levered of any of the major investment facilities that we sort of have oversight on this committee.

So it is still a very, very small thing. And all of the rest of the financial matters that you see on the board have the same issues that Mr. Himes may have raised. So if we want to start worrying about layering on leverage, maybe the place to start is on the left side of that graph and not the right side of that graph. Thank you. You can take that down.

Regarding the buckets, it strikes me—and Mr. Himes raised this as well. While I understand his point about perhaps his suggestion of not allowing it in the financial services area, part of the reason we are doing this is because small and medium-sized financial institutions are having difficulty getting the capital.

So that is actually one of the expected uses in my district. I am a very rural area. We are heavily community-banked. And we are trying to figure out a way to provide them with additional sources of capital.

Plus, it strikes me that a well-run community bank or small financial institution would probably carry less leverage than some of the operating companies that Mr. Himes mentioned. So I don't think it is a connection between leverage and the bill.

I think it comes down to, can we make smart, safe, sound capital available to as many people as possible? That is the purpose of the bill. And I see no reason to arbitrarily limit it to having financial institutions getting one level of leverage into operating companies, for lack of a better word, getting another.

Mr. Lynch mentioned go-around on Volcker. I will throw this to the panel because it strikes me, gentlemen, that if I was—you mentioned Goldman Sachs. I can't remember the European bank you mentioned that was thinking about doing this. If I wanted to get around Volcker, there are a lot better ways to do it than invest in BDCs aren't there, Mr. Gerber?

Mr. GERBER. As Mr. Arougheti said, Volcker doesn't apply to us. But I do think that when we see banks investing in BDCs, it is actually a positive consequence to some degree to the Volcker Rule in that those assets are no longer on the bank's balance sheet. And they are now being invested in a far more transparent environment than in a merchant banking private operation.

So, from our perspective, we don't—Volcker doesn't apply to us. But in looking at it, it doesn't seem to us to be an end-run around Volcker.

Mr. MULVANEY. Right. And that is a good point that I don't think that lots of folks are familiar with; when you say Volcker doesn't apply to you, that is not by accident. The Rule actually specifically excludes you folks under the rationale that these industries are already so heavily regulated and so transparent that there was no reason to apply Volcker to you folks.

And again, I would suggest that if I am Deutsche Bank or Goldman Sachs and I want to go around Volcker, I can put my money in a hedge fund and do it right away. I don't have to go through the hassle of going through the BDC application.

Dr. Brown, you mentioned something at the very outset of your testimony about operating companies versus financial institutions. And again, I don't want to change your words. But I thought you said something to the tune of the operating companies need it more than the financial institutions. Or—

Mr. BROWN. No, I don't think I quite said that, although who knows, I could have misspoken. What I really said was I haven't seen the empirical data that says the financial companies need it.

What we know is the operating companies do need it. And I am afraid of the bleed of funds away from operating companies to financial companies and hurting those companies.

And I would just add, Congressman, that the comment that was made earlier about these operating companies getting not only the funds, but getting the managerial assistance, I don't know whether the financial companies need the managerial assistance in the same way I think a lot of these operating companies do.

So I think if that these operating companies can't access as easily these BDCs, I think that is a problem for the operating company.

Mr. MULVANEY. Two things to consider, Mr. Brown, and to my colleagues of both parties.

Number one, it seems that the need for the product would be dictated by the market and not by some empirical research. Either it is there or it is not there. But perhaps more importantly to your point, if these gentlemen want to take an equity position or a debt position in a community bank in my district, I know where the money is going, which is to the local businesses.

So it is just another way to get the money to the operating companies. That is what the community banks and the small financial institutions and small investment operations in my district do. So if the demand is there within the operating business community, I think it probably—capital should be able to find a way there.

Lastly, Mr. Brown, I will close with this. I have 14 seconds.

You mentioned some concern about the different levels of stock, the different classes of stock, the preferred stock. And I guess I can only ask it this way.

Wouldn't those concerns that you raised here today apply to any company that offers preferred stock? Because a lot of publicly traded companies that I could buy this afternoon offer preferred stock. Aren't your concerns equally applied to them as they would be to BDCs?

Mr. BROWN. Well, of course, not investment companies, but operating companies, yes.

Mr. MULVANEY. Right. But if I am an investor, I am either going to invest in BDCs or I am going to invest in Norfolk Southern Railway and they might have a preferred stock and the BDCs might have a preferred stock. And the concerns that you raise would apply equally to me as investor as between BDC and Norfolk Southern.

You said the board of directors could change the voting rights, they could change the payouts. They could, think about me as an unsophisticated investor, might get caught in that. That applies anyway, right, in the market.

Mr. BROWN. You are absolutely right. The legal authority exists irrespective of the company because it is the authority of the board of directors. But what I would say right now, is there are protections in the Investment Company Act of 1940 that don't exist for other companies. So we are talking about removing something that is there that does not apply to operating companies.

Mr. MULVANEY. Fair enough. Gentlemen, I appreciate the additional 50 seconds, and for the right to participate in the hearing since I am not on the subcommittee. Thank you, Mr. Garrett.

Chairman GARRETT. Thank you. And welcome to the subcommittee.

So I said that was going to be the last word, but, no, I am not going to say the last word. I am going to give the last word to the gentlelady from New York.

Mrs. MALONEY. A vote has been called. But very briefly, thank you to all of the panelists. And I ask unanimous consent to place two letters into the record: one from the North American Securities Administrators Association; and one from the Consumer Federation of America and Americans for Financial Reform.

And I look forward to continuing to work with you, Mr. Mulvaney, to see if we can get a product that has unanimous bipartisan support. Getting capital out is important. Thank you.

Chairman GARRETT. Without objection, is is so ordered. And again, thank you to the witnesses.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And with that, this hearing is adjourned. And again, thank you to the panel.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

A P P E N D I X

June 16, 2015

TESTIMONY OF

MICHAEL J AROUGHETI
CO-CHAIRMAN OF THE BOARD OF DIRECTORS
ARES CAPITAL CORPORATION

BEFORE THE

HOUSE SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

" LEGISLATIVE PROPOSALS TO MODERNIZE BUSINESS DEVELOPMENT COMPANIES AND EXPAND INVESTMENT OPPORTUNITIES"

JUNE 16, 2015

I. Introduction

Chairman Garrett, Ranking Member Maloney and members of the Sub-Committee, thank you for the opportunity to testify today. My name is Michael Arougheti and I am the Co-Chairman of the Board of Directors of Ares Capital Corporation, an SEC registered Business Development Company, or "BDC", and one of the largest non-bank providers of capital to small- and medium-sized American companies – the backbone of the U.S. economy. Ares Capital Corporation is publicly-traded on the NASDAQ National Market and is currently the largest publicly-traded BDC by both market capitalization and assets. Since our IPO in 2004 through March 31, 2015, we have invested more than $20 billion in more than 650 transactions with hundreds of small and medium sized American companies, in the process creating tens of thousands of new jobs and providing capital to growing businesses who were unable to access capital through commercial banks or other traditional financing sources.

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". The stated objective of BDCs was to encourage the establishment of new market vehicles to invest in, and increase the flow of capital to, private businesses. By mandate, BDC's are also required to provide managerial assistance to their portfolio companies. Uniquely, the BDC model gives ordinary investors the opportunity to finance small and medium size companies – effectively "Main Street funding Main Street".

Today there are 57 publicly-traded BDCs with an aggregate market capitalization of more than $45 billion and approximately $77 billion in assets. This in the aggregate would place the **entire** BDC industry as the 30th largest bank in the country by assets.[1] While the scope of BDC's investments may vary, all BDCs share a common investment objective of improving capital access. As commercial banks and other traditional financing sources continue to retrench from the business of providing loans to small and medium size companies, BDCs now find themselves at the forefront of the effort to address the unmet capital needs of these companies.

Today, the middle market sector of the economy is responsible for one-third of private sector GDP[2] and BDCs have grown as commercial banks have withdrawn from lending to this sector. Specifically, middle market leveraged lending by commercial banks has decreased from a peak of 60% in 2001 to 1.5% in Q1 2015.[3] Perhaps the most striking example of this retrenchment is GE Capital's recently announced exit from the U.S. middle market lending space. As the seventh largest bank in the United States, GE Capital provided a significant amount of capital to small and medium sized businesses and its exit from this market will surely have a significant impact on the future availability of capital to support the growth of these businesses and the jobs that they provide.

The impact of BDC's on small and medium sized businesses has been tangible and meaningful. By way of example, in 2008 Ares Capital Corporation made an initial investment in OTG Management Inc., a founder-owned operator of full service sit-down and quick-service restaurants, bars, lounges, gourmet markets, and news and gift shops based in airports in the

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[1] Source: Federal Reserve Statistical Release, December 31, 2014, www.federalreserve.gov/Releases/Lbr/current/default.htm

[2] Source: National Center for the Middle Market www.middlemarketcenter.org/performance-data-on-the-middle-market.

[3] Source: Middle Market Quarterly Review 1Q14 S&P Capital IQ; 1Q 2015 High End Middle Market Lending Review: S&P Capital IQ

United States. and Canada. OTG was awarded a contract to build-out and operate the food and beverage concessions at JetBlue's new Terminal 5 at New York's JFK International Airport and needed to raise capital to complete the construction plan. However, OTG was a small company with limited operating history at the time and therefore, financing from a traditional senior debt provider or a private equity firm was not an option to provide what OTG was looking for. Traditional senior debt providers were not an option as their proposed capital was limited, inflexible, had a low tolerance for risk, and as OTG won new contracts, they could not provide a sufficient amount of incremental capital to fund these future activities. Similarly, private equity sources of capital were not an option as they wanted to be able to force liquidity within a certain time frame, which was incompatible with a private company that wished to preserve autonomy and invest in growth over the long term. Because BDCs such as Ares Capital Corporation are "permanent capital" vehicles, they often have a longer investment horizon and can provide more flexible capital to companies like OTG. Ares Capital Corporation not only provided capital for the build-out of JetBlue's Terminal 5 at New York's JFK International Airport, but has since become a strategic financing partner to the Company and provided capital to support multiple airport projects around the country. In addition, Ares Capital Corporation took seats on OTG's board of directors and has provided valuable strategic advice and support to the company as it grew.

While the BDC industry continues to grow, I strongly believe that we can expand our scope and do more to fulfill our policy mandate. To that end, I am here today along with others in the BDC industry to express support for proposed legislation that seeks to make common sense, prudent changes to the Investment Company Act of 1940 in order to enable BDCs to more easily raise and deploy capital to small and medium size businesses. **It is important to note that BDCs are not seeking any government or taxpayer support or subsidy**. The BDC industry is simply asking Congress to modernize the applicable regulatory framework so that BDCs can more easily fulfill their Congressional mandate.

II. Policy Challenges / Proposed Policy Solutions

BDCs are heavily regulated by the SEC and appropriately, the activities of BDCs are fully transparent to regulators, investors and portfolio companies. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. These disclosure and other regulatory requirements are extensive and include, among other things, a requirement that BDCs publish a quarterly summary of each investment held by a BDC and the fair value of such investment. This is a significantly greater degree of transparency than that found in other financial services models.

While we certainly believe in the importance of appropriate regulation, many of the challenges faced by BDCs in increasing the amount of capital that they can raise and deploy are a consequence of where BDCs sit in the regulatory framework. BDCs are more akin to operating companies such as banks and other commercial lenders, yet are regulated as mutual funds. Consequently, BDCs must often play the part of the proverbial "square peg in a round hole".

So, the question then becomes how to enable BDCs to fulfill their Congressional mandate of being an active provider of capital to small and medium sized companies, while remaining appropriately regulated and transparent?

The answer – begin the process of modernizing the regulatory framework with a handful of modest, common sense changes. Clearly, the world is a much different place than it was in 1980 when Congress created BDCs.

One of the important lessons learned by BDCs during the "Great Recession" was that during a downturn, certain parts of the existing regulatory framework applicable to BDCs constrained their mission to deploy capital to small and medium sized companies. As you know, in the last Congress the House Financial Services Committee passed H.R. 1800, which sought to mitigate/eliminate a number of these structural constraints.

Today, I am here to offer support for the draft of the "Small Business Credit Availability Act" being offered by Mr. Mulvaney. This draft builds on H.R. 1800 and other bipartisan efforts in the previous Congress to modernize BDC legislation. In short, the proposed bill seeks to enable BDC's to "do more" than they are currently able to in terms of the number of companies that they can lend to, the types of investments they can make and the amount of capital that they can raise and deploy. At the same time, the proposed bill contains provisions designed to ensure that BDCs continue to be appropriately regulated and subject to stringent standards regarding transparency and shareholder protection.

The proposed bill contains five provisions, each of which we believe will enable BDCs to more effectively fulfill their Congressional mandate today and in the future .

- **First**, like H.R. 1800, the proposed bill contemplates an increase in the BDC asset coverage test from 200% to 150%, thereby broadening the universe of potential borrowers that can access loans from a BDC. However, under the proposed bill such an increase would now be subject to the following shareholder-friendly conditions:
    - Prior to adopting such increase, the BDC must receive the approval of:
        - At least a majority of its disinterested directors, in which case such an increase would become effective one year after such approval[4]; **or**
        - More than 50% of the votes cast at an annual or special meeting of its shareholders, in which case such an increase would become effective immediately following such approval.
    - The BDC must file a Current Report on Form 8-K disclosing the effective date of such approval as well as information relating to the BDCs outstanding senior securities and its asset coverage ratio. The same disclosure, along with the principal risk factors associated with any increased leverage, must also be included in a BDC's periodic filings under the Securities Exchange Act of 1934.

[4] For BDCs that are not publicly traded on a national exchange, such approval shall not become effective until such BDC offers to repurchase from each shareholder the equity securities held by such shareholder as of the board approval date, with 25% of such equity securities to be repurchased in each of the four quarters following such board approval date.

We do not believe that the proposed change introduces more risk. Rather, it should allow BDC's to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test actually forces BDC's to invest in riskier, higher-yielding securities in order to meet the dividend requirements of their shareholders. This potential "de-risking" is further supported by the strong underlying performance of the loan asset class. For example, during the period from our IPO through March 31, 2015, ARCC's average non-accrual rate on first lien senior secured loans was 2.19% while the average default rate of the S&P LSTA Leveraged Loan Index for first lien senior secured loans for that same period was 2.53%.[5] Similarly, since inception BDCs have generated a cumulative gain/loss rate of negative 17 bps, outperforming banks by 219 bps.[6] We believe that this proposed change will benefit borrowers through greater financing alternatives and a reduced cost of capital and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios. In addition, the markets have already acknowledged a willingness to provide increased leverage to acquire these higher credit quality assets.

In addition, this proposed change would apply to BDCs the same leverage ratio as the leverage ratio for Small Business Investment Companies but, unlike SBICs, without putting any government capital at risk. This seems prudent, consistent with other legislation that this sub-committee has passed and, as I noted, benefits both small and medium sized companies and shareholders without any government or taxpayer subsidy. Given that the House Small Business Committee just last week passed bipartisan legislation increasing the size of the SBIC program, the requested modifications to the regulatory framework governing BDCs certainly seems reasonable. This proposed change is also extremely modest given that banks customarily incur leverage of 10:1 and greater.

An increase in this ratio will also provide additional "cushion" given the requirement that BDC's must "mark to market" their loans each quarter. Specifically, in the event of falling asset values in the overall market as we saw during the Great Recession, unlike banks and other commercial finance companies BDCs are generally required to write down the value of certain of their otherwise performing assets. Currently, most BDCs have an average leverage ratio of 0.5x-0.75x, reflecting a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep drop in asset values. However, the maintenance of such a cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress. This additional cushion would provide BDCs with the ability to deploy more capital in the ordinary course and through market cycles.

[5] Source: S&P LCD data for LSTA Leveraged Loan Index. Calculated as the average of last twelve months rolling monthly first lien default rates over the period from October 2004 through March 2015.

[6] The 2Q 2015 BDC Scorecard, Wells Fargo

Finally, given the transparency required of BDCs in their SEC disclosure documents, which has been further enhanced in the proposed legislation, shareholders will be clearly informed (as they are now) of the amount of leverage that BDCs can incur and any potential risks to them associated with such leverage.

- **Second**, the proposed bill would allow BDCs to issue multiple classes of preferred stock and, solely for preferred stock issued to Qualified Institutional Buyers (and not retail investors), eliminate the requirement that holders of preferred stock have board representation. During the last downturn, many BDCs were challenged with respect to issuing common equity at a price below net asset value. Had BDCs been able to raise capital during the post 2008 period by issuing preferred shares as equity, many more loans could have been made to cash-starved companies to enable them to retain employees and, in some instances, to remain in business.

- **Third**, the proposed bill directs the SEC to make specific technical amendments to certain securities offering rules applicable to BDCs. Currently, despite the need for regular access to the capital markets, BDCs are the only seasoned issuers required to comply with certain provisions of the 1933 Act which, in turn, makes raising capital cumbersome and inefficient. These rule changes would merely place BDCs on equal footing with non-BDC's without any accompanying decrease in transparency or shareholder protection.

- **Fourth**, the proposed bill would allow BDCs to own registered investment advisers, which as a technical matter is currently prohibited under the 1940 Act. Investments in RIAs enable money to be raised from third party investors which, in turn, can be deployed to small and medium-sized companies.

- **Fifth**, the proposed bill would offer welcome flexibility for BDCs to invest in entities currently limited by the existing 30% basket. For example, a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context may seem arbitrary. Of note, this provision of the draft legislation would **not** allow the amount of the incremental increase in the 30% basket to be invested in private equity funds, hedge funds or collateralized loan obligations (CLOs).

III. Closing Remarks

In conclusion, we believe that the time is right to modernize regulations governing BDCs and pass legislation which would allow BDC's to increase capital flows to America's small and medium size companies, spur economic growth and create jobs. It is clear that banks have left this space and will not return. We are hopeful that there will once again be a bi-partisan focus on this important initiative, and look forward to working with the Committee in moving this bill forward.

On behalf of the entire BDC sector, I'd like thank Representative Mulvaney for his efforts and urge the sub-Committee to act favorably on a BDC modernization bill. Again, I appreciate the opportunity to testify today and would be pleased to answer any questions.

Testimony:

Reforming the Definition of Accredited Investor and Business Development Companies

J. Robert Brown, Jr.[1]

The federal securities laws were designed to protect investors by ensuring that they had adequate disclosure whenever an issuer sold securities. The private placement exemption is an exception to this approach. These offerings often involve companies with high risk, little publicly available information, and illiquid trading markets. They frequently fail.[2]

The accredited investor concept seeks to ensure that unregistered investments are sold only to persons who can fend for themselves.[3] The accredited investor standard currently relies on dollar thresholds as an objective substitute for sophistication. Agreement exists that the definition requires reform. The debate is over how to best ensure that the definition covers persons who have the requisite degree of sophistication and excludes those who do not.

With respect to Business Development Companies, these entities play an important role in providing funding to "small growing and financially troubled enterprises."[4] Taking steps to facilitate the ability of BDCs to better provide financing to these enterprises is an important goal. Increasing the leverage limits as proposed in this legislation seems an appropriate method of advancing this goal. Altering the definition of eligible portfolio company, however, raises the risk that this much needed source of funding will be redirected away from operating companies, reducing the capital available to these businesses.

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[1] Professor of Law, University of Denver Sturm College of Law; Secretary, Investor Advisory Committee, Securities & Exchange Commission. The IAC has made a recommendation with respect to the definition of accredited investor which I support. Nonetheless, this testimony does reflect my views and does not necessarily reflect the views of the IAC or its members.

[2] *See* Exchange Act Release No. 70741 (Oct. 23, 2013) ("a 2010 study reports that of a random sample of 4,022 new high-technology businesses started in 2004, only 68% survived by the end of 2008. Other studies also have documented high failure rates for small newly listed companies. For example, the ten-year delist rate for newly listed firms during the period 1981-1991 is 44.1%, compared to 16.9% for newly listed firms in the 1970s.").

[3] Securities Act Release No. 6683 (Jan. 16, 1987) ("This concept [of accredited investor] is intended to encompass those persons whose financial sophistication and ability to sustain the risk of loss of investment or ability to fend for themselves render the protections of the Securities Act's registration process unnecessary. ").

[4] Investment Company Act Release No. 12274 (March 5, 1982).

I. Accredited Investors

A. Background

The Commission adopted the test for individuals qualifying as accredited investors in 1982.[5] The rule was an appropriate response to the concerns that existed at the time. Under the reigning case law, private placements were largely limited to sophisticated investors who were deemed not to need the protections of the securities laws.[6] As a judicially developed doctrine, however, sophistication was an amorphous and uncertain concept.[7]

The Commission responded to the concern by opting for an objective standard in determining sophistication. Accredited investors included anyone with a net worth of $1 million or in excess of $200,000 a year in income over a multiple year period. The SEC understood that dollar amounts alone did not always act as an adequate substitute for sophistication. As a result, the amounts were deliberately set at very high levels[8] in an effort to ensure that most investors were likely to be sophisticated or at least wealthy enough to retain the necessary expertise.[9]

When the definition was originally adopted, a second mechanism existed for ensuring that investors purchasing unregistered securities were actually sophisticated. Private placements under Rule 506 could not be sold through general solicitations, largely eliminating indiscriminate marketing efforts. As a result, most investors participating in private placements likely had preexisting relationships with, and were known to, their brokers.[10] Brokers confronting investors

[5] Revision of Certain Exemptions From Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389 (Mar. 8, 1982).
[6] *See Securities and Exchange Commission v. Ralston-Purina Co.*, 346 U.S. 119 (1953).
[7] *See* Securities Act Release No. 5487 (April 23, 1974) ("The application of these criteria [from Ralston] and other guidelines set forth from time to time by the Commission and the courts has resulted in uncertainty about the availability of the exemption. In addition, some misconceptions have arisen in connection with certain methods used by persons who seek to claim the exemption.").
[8] Thus, rather than determine the appropriateness of particular types of assets included in the test, the Commission actually increased the thresholds from what had been proposed, presumably eliminating the need to make such determinations. *See* Securities Act Release No. 6389 (March 8, 1982) ("Some commentators, however, recommended excluding certain assets such as principal residences and automobiles from the computation of net worth. For simplicity, the Commission has determined that it is appropriate to increase the level to $1,000,000 without exclusions.").
[9] Approximately 1.8% of families qualified as accredited in 1982. Commissioner Luis A. Aguilar, Revisiting the "Accredited Investor" Definition to Better Protect Investors, US SEC, Dec. 17, 2014, n. 3, *available at* http://www.sec.gov/news/statement/spch121714laa.html#_ednref3 The percentage increase to 7.4% by 2010. *See* Exchange Act Release No. 69959 (July 10, 2013) ("We estimate that at least 8.7 million U.S. households, or 7.4% of all U.S. households, qualified as accredited investors in 2010, based on the net worth standard in the definition of 'accredited investor'").
[10] Exchange Act Release No. 69959 (July 10, 2013) ("While we do not know what percentage of investors in Rule 506 offerings are natural persons, the vast majority of Regulation D offerings are conducted without the use of an intermediary, suggesting that many of the investors in Regulation D offerings likely have a pre-existing relationship with the issuer or its management because these offerings would not have been conducted using general solicitation."), *available at* http://www.sec.gov/rules/final/2013/33-9415.pdf.

who met the dollar thresholds under the definition but in fact were not sophisticated were in a position to moderate their recommendations accordingly.

The dollar thresholds set out in the original rule have largely remained unchanged for more than 30 years.[11] At the same time, however, the financial landscape has undergone a tectonic shift. The markets have grown in complexity. Most significantly, however, has been the shift away from pensions to defined contribution plans. As a result, individuals have needed to assume increased responsibility for managing their retirement nest egg. Defined contribution plans have also provided a massive pool of funds for investment.[12] As one SEC official put it back in 2000, this has caused "a massive movement of middle America into the securities markets".[13]

Likewise, the number of retirees has undergone sustained growth. The oldest members of the Baby Boom generation celebrated their 65th birthday in 2011. Every day thereafter 10,000 baby boomers have reached the age of 65 and will continue to do so until 2030.[14] Many of these older investors are unsophisticated and "lack even a rudimentary understanding of stock and bond prices, risk diversification, portfolio choice, and investment fees."[15]

As retirement funds held by individuals have increasingly become available for investing, the method of marketing private placements has likewise changed. With the end to the prohibition of general solicitations, individual investors can be solicited through indiscriminate forms of mass marketing, including blast emails, ads on the Internet,[16] infomercials on cable television, or seminars offering inducements such as "free" meals.[17] FINRA has issued notices about offers involving "pre-IPO shares,"[18] high yield investment programs,[19] and investment in

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[11] The thresholds have not changed. The definition with respect to individuals has, however, been amended on several occasions. Most recently, the definition was changed to exclude the value of the primary residence from the calculation of net worth. *See* Securities Act Release No. 9287 (Dec. 21, 2011). The definition was also amended in 1988 to provide that families qualified with an income of $300,000 and to eliminate a test based upon the amount invested. *See* Securities Act Release No. 6758 (March 3, 1988) (eliminating qualification as accredited where investor with $750,000 in net assets purchases at least $150,000 in a single investment).

[12] Assets in defined contribution plans have grown dramatically, going from less than $200 billion in 1980, http://www.ici.org/pdf/per12-02.pdf, to almost $4 trillion in 2014. *See* http://www.americanbenefitscouncil.org/documents2013/401k_stats.pdf

[13] https://www.sec.gov/news/speech/spch369.htm ("In 1980, that number [of American households that invested in a mutual fund] was one out of 18."). The percentage of families with mutual funds today is almost 50%. *See* http://www.ici.org/pdf/per19-09.pdf

[14] http://www.pewresearch.org/daily-number/baby-boomers-retire/

[15] http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part2.pdf

[16] *In re Spectrum Concepts, LLC*, Release No. 770 (admin proc April 7, 2015) (information about an offering allegedly posted "on a classified advertisement website in order to attract investors broadly.").

[17] https://www.finra.org/investors/alerts/free-lunch-investment-seminars%E2%80%94avoiding-heartburn-hard-sell ("In a 2007 report, securities regulators, including FINRA, the U.S. Securities and Exchange Commission, and state regulators, conducted more than 100 examinations involving free-meal seminars. In half the cases, the sales materials—including the invitations and advertisements for the events—contained claims that appeared to be exaggerated, misleading or otherwise unwarranted. And 13 percent of the seminars appeared to involve fraud, ranging from unfounded projections of returns to sales of fictitious products.").

[18] https://www.finra.org/investors/alerts/pre-ipo-offerings%E2%80%94these-scammers-are-not-your-friends ("For instance, in late December 2010, shortly after the Securities and Exchange Commission settled a civil action, federal prosecutors brought criminal charges against a self-employed securities trader who allegedly bilked more than 50 U.S. and foreign investors out of more than $9.6 million in a series of pre-IPO scams spanning an eight-year period.

the marijuana business.[20] The use of general solicitations increases the likelihood that those invited to participate in an unregistered offering will not have a pre-existing relationship with the issuer or broker.[21]

As a practical matter, therefore, private placements are likely to be offered increasingly to investors lacking in adequate sophistication and who have, as a primary source of liquidity, funds in retirement plans. The definition of accredited investor should, therefore, take these altered dynamics into account. The definition should not be written to sweep into the category large swathes of people who in fact are not sophisticated and are not able to adequately assess the risks of the these investments.

B. The Direction of Reform

With respect to reform, there is probably more agreement than disagreement. For one thing, the accredited investor definition never made room for persons who were in fact sophisticated. For another, the dollar thresholds, as currently formulated, are not an adequate guarantee of accredited investor status.[22] There seems to be agreement that, at a minimum, the numerical thresholds were arbitrary when determined[23] and require reexamination.[24]

We were also aware of other potentially fraudulent schemes that solicited potential victims by purporting to sell shares of Facebook."). *See also SEC v. Premier Links*, Inc., Litigation Release No. 23163 (Dec. 19, 2014) (allegations that seniors were "cold-called" and subjected to "high-pressure sales tactics to convince seniors to invest in companies purportedly on the brink of conducting initial public offerings").

[19] https://www.finra.org/investors/alerts/hyips%E2%80%94high-yield-investment-programs-are-hazardous-your-investment-portfolio ("HYIPs use an array of websites and social media—including YouTube, Twitter and Facebook—to lure investors, fabricating a 'buzz' and creating the illusion of social consensus, which is a common persuasion tactic fraudsters use to suggest that 'everyone is investing in HYIPs, so they must be legitimate.'").

[20] http://www.finra.org/investors/alerts/marijuana-stock-scams

[21] Remarks of SEC Commissioner Luis A. Aguilar, "The Importance of Small Business Capital Formation", 33rd Annual SEC Government-Business Forum on Small Business Capital Formation, Nov. 20, 2014, Washington, DC, *available at* http://www.sec.gov/info/smallbus/gbfor33.pdf ("In addition, the definition of 'accredited investor' has taken on greater meaning now that issuers can engage, without registration, in unlimited advertising and solicitation, so long as the ultimate purchasers are accredited investors. Given the importance of this definition in helping to identify investors that are presumably sophisticated and financially able to invest in illiquid securities, the accredited investor definition is particularly important.").

[22] Recommendation of the SEC's Investor Advisory Committee: Accredited Investor Definition, Oct. 9, 2014 ("IAC Recommendation"), *available at* https://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf ("the current definition of net worth does not guarantee that the individual accredited investor will in fact have sufficient liquid financial assets to ensure either that they can hold the securities indefinitely or that they can withstand a significant loss on those investments.").

[23] *See* Speech by Michael S. Piwowar, *Capital Unbound*, Remarks at the Cato Summit on Financial Regulation, NY NY, June 2, 2015 ("As the Commission's Investor Advisory Committee has pointed out, simply adjusting the tests for inflation may not be the right answer. We do not know, for instance, if the levels set in 1982 were right to begin with. Were they too high or too low? Further, a single national threshold might be both under-inclusive and over-inclusive at the same time: earning $200,000 a year in rural Iowa is quite different than making $200,000 here in New York City.").

[24] The GAO Report on the definition of accredited investor showed a division among those responding on whether the dollar thresholds should be increased. *See Alternative Criteria for Qualifying As An Accredited Investor Should be Considered*, GAO Report No. 13-640, July 2013. Objections to an increase often focused on the perceived impact on the total pool of investors. Id. at 17. This may, however, be mitigated to the extent that the definition is

A strong starting place for any reforms should be the recommendations made by the SEC's Investor Advisory Committee with respect to the definition of accredited investor.[25] These include:

Recommendation 1. The Commission should carefully evaluate whether the accredited investor definition, as it pertains to natural persons, is effective in identifying a class of individuals who do not need the protections afforded by the '33 Act. If, as the Committee expects, a closer analysis reveals that a significant percentage of individuals who currently qualify as accredited investors are not in fact capable of protecting their own interests, the Commission should promptly initiate rulemaking to revise the definition to better achieve its intended goal.

The Supporting Rationale for the recommendation discussed categories of investors who meet the income and net worth thresholds but arguably do not qualify as sophisticated. Nonetheless, this does not necessarily mean that the appropriate fix is to simply adjust the thresholds for inflation. As the supporting statement noted:

> we do not know with any certainty whether the Commission found exactly the right level when it set those thresholds originally. It is equally possible that they were set either too low or too high to provide the needed investor protections. Moreover, the investing population has changed significantly since that time, with a larger percentage of unsophisticated, middle income individuals turning to the securities markets to save for retirement today than did so 30 years ago. The complexity of financial products, including financial products sold through private offerings, has also grown in the intervening years. Thus, thresholds that made sense for the investing population of 1982 may or may not make sense in 2014.

The analysis suggested consideration of alternative approaches that looked to the types of assets included in the determination. In particular, the Supporting Rationale noted that "there may be certain types of financial assets, such as retirement accounts, that should not be included in the calculation."

Recommendation 2. The Commission should revise the definition to enable individuals to qualify as accredited investors based on their financial sophistication.

The Supporting Statement acknowledged three mechanisms for establishing sophistication -- professional credentials, investment experience, and a test of relevant financial knowledge. Credentials that might qualify included the series 7 securities license. Experience might include acting as a professional in the financial industry or private equity sector for a

simultaneously changed to permit investors to qualify as accredited on the basis of actual sophistication, including experience.

[25] IAC Recommendation, *supra* note 22 ("The Committee does not believe that the current definition as it pertains to natural persons effectively serves this function in all instances. ").

specified period or actual investment experience. Finally, testing would need to be sufficiently rigorous to "indicate a reasonable level of relevant financial expertise."

Recommendation 3. If the Commission chooses to continue with an approach that relies exclusively or mainly on financial thresholds, the Commission should consider alternative approaches to setting such thresholds – in particular limiting investments in private offerings to a percentage of assets or income – which could better protect investors without unnecessarily shrinking the pool of accredited investors.

As the Supporting Rationale notes, the current definition is essentially an "on/off switch." Once an investor qualifies as accredited, there are no limits on the amount that can be invested. On possible approach, therefore, might be to limit the amount of investment as a percentage of income or assets. The restrictions could be reduced or eliminated as assets and income increase.

Recommendation 4. The Commission should take concrete steps to encourage development of an alternative means of verifying accredited investor status that shifts the burden away from issuers who may, in some cases, be poorly equipped to conduct that verification, particularly if the accredited investor definition is made more complex.

Recommendation 5. In addition to any changes to the accredited investor standard, the Commission should strengthen the protections that apply when non-accredited individuals, who do not otherwise meet the sophistication test for such investors, qualify to invest solely by virtue of relying on advice from a purchaser representative. Specifically, the Committee recommends that in such circumstances the Commission prohibit individuals who are acting as purchaser representatives in a professional capacity from having any personal financial stake in the investment being recommended, prohibit such purchaser representatives from accepting direct or indirect compensation or payment from the issuer, and require purchaser representatives who are compensated by the purchaser to accept a fiduciary duty to act in the best interests of the purchaser.

* * *

These recommendations suggest that the definition should be reconsidered holistically and not in a piecemeal fashion. Moreover, the holistic approach is more likely to result in an outcome that ensures a definition that excludes investors who continue to need the protections of the securities laws and ensures that issuers have a greater ability to engage in cost effective offerings in reliance on the private placement exemption.

C. HR 2187

HR 2187 seeks to address some but not all of the current concerns that exist under the accredited definition standard. Significantly, the draft legislation would extend the definition of accredited investor to persons who have no demonstrated capacity to absorb the loss should any particular investment fail. As a result, even greater care should be taken to ensure that an approach based upon education, experience and testing but without reliance on financial thresholds does not accidentally sweep into the definition persons who are in fact not sophisticated.

1. Automatic Accredited Investor Status

The legislation seeks to provide automatic accredited investor status to any person described in paragraphs (1), (2), (3), or (4) of section 506(c)(2)(ii)(C), irrespective of the income and net worth requirements. The provision specifically lists:

(*1*) A registered broker-dealer;

(*2*) An investment adviser registered with the Securities and Exchange Commission;

(*3*) A licensed attorney who is in good standing under the laws of the jurisdictions in which he or she is admitted to practice law; or

(*4*) A certified public accountant who is duly registered and in good standing under the laws of the place of his or her residence or principal office.[26]

To the extent that the provision is intended to extend accredited investor status to registered representatives employed by brokers,[27] these individuals generally must pass a Series 7 exam issued by FINRA and therefore have some knowledge and background on investments.[28] They also have continuing education requirements.[29]

To the extent that the provision is intended to extend accredited investor status to investment adviser representatives,[30] these individuals generally must have completed a Series 65 exam.[31] As a result, they also generally have some knowledge and background on

[26] Rule 506(c)(2)(ii)(C), 17 CFR 230.506(c)(2)(ii)(C).
[27] The bill currently references registered broker-dealers. Rule 501(a)(1) extends the definition of accredited investor to "any broker or dealer registered pursuant to Section 15" of the Exchange Act. 17 CFR 230.501(a)(1).
[28] http://www.finra.org/sites/default/files/Series_7_Study_Outline.pdf
[29] For brokers, see FINRA Rule 1250, Continuing Education Requirements, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=10204
[30] With respect to investment advisers, firms may sometimes register with the SEC but their representatives do not. *See* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf ("Although many individuals who are employed by advisers fall within the definition of 'investment adviser,' the SEC generally does not require those individuals to register as advisers with the SEC. Instead, the advisory firm must register with the SEC.").
[31] The exam is the responsibility of NASAA but administered by FINRA. *See* http://www.finra.org/industry/series65 For an outline of the content of the exam, see http://www.nasaa.org/wp-content/uploads/2011/08/Series-65-Exam-Specification.pdf

investments. They are not, as a result of registration, generally subject to continuing education requirements.[32]

In contrast, the 1,266,158 active lawyers do not possess sufficient indicia of sophistication either through education or experience.[33] There is nothing inherent in a legal education that ensures lawyers will be sophisticated with respect to investments in unregistered securities. Courses at law schools that might provide meaningful understanding of investments such as Corporate Finance are not typically required.[34] Moreover, even courses such as those providing background on the federal securities laws, including the exemptions from registration, typically emphasize legal compliance and do emphasize the types of investments available in the market or their level of risk. Nor do lawyers necessarily obtain that expertise as a result of their practice area.[35] The likelihood that this change will sweep into the definition of accredited a large number of investors who in fact are not sophisticated is very high.[36]

Finally, the legislation may have unintended harmful consequences. The legislation leaves out other categories of persons likely to be sophisticated. It does not take into account persons who are sophisticated as a result of relevant education or actual experience. To the extent that this legislation was adopted, the incentive by regulators to revise the definition in other ways would be overtaken by the need to implement the legislation.

2. Self-Certification

HR 2187 provides that these four categories of persons will be treated as accredited "if such person certifies to the issuer prior to the sale of securities" that he or she fits within one of the aforementioned categories.

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[32] http://www.nasaa.org/industry-resources/exams/exam-faqs/#25 ("There are no continuing education requirements for NASAA exams at the present time."). The exam only needs to be retaken if there is a two year lapse in association with a registered investment adviser. *See* http://www.nasaa.org/industry-resources/exams/exam-faqs/ ("When an individual first passes an exam, that person has two years to become licensed (registered) with a state or the exam expires. Once registered, the exam remains valid as long as the person stays registered. When a registered person's job is terminated (usually reflected by the filing of a Form U5 by the employer), the state registration terminates as well. The individual then has two years to be re-employed and re-registered or the exam will be shown as "expired" in the Central Registration Depository (CRD).").

[33] https://lawschooltuitionbubble.wordpress.com/original-research-updated/lawyers-per-capita-by-state/

[34] http://www.americanbar.org/content/dam/aba/publications/misc/legal_education/2012_survey_of_law_school_curricula_2002_2010_executive_summary.authcheckdam.pdf ("The number of law schools that required courses beyond the first year has remained relatively constant since 2002, with Constitutional Law and Evidence garnering the most support as required upper division doctrinal courses. For the first time, 28% of law school respondents indicated that they required a specific upper division legal writing course.").

[35] For a demographic break down of lawyers and their employment, see http://www.americanbar.org/content/dam/aba/migrated/marketresearch/PublicDocuments/lawyer_demographics_2012_revised.authcheckdam.pdf

[36] The inclusion of lawyers and CPAs into Rule 506 (c)(2)(ii)(C) was unrelated to investment acumen. They were deemed appropriate categories of persons to verify accredited investor status. The Commission was not concerned with their knowledge of investments but their professional competence and ethical standards. *See* Exchange Act Release No. 9415 (July 10, 2014) ("in the United States, attorneys and certified public accountants are licensed at the state level and are subject to rules of professional conduct"). Verifying the amount of income or the value of assets is very different than understanding the risks associated with an unregistered security.

The language suggests that issuers will only need to obtain the requisite certification without having to undertake additional verification. To the extent true, the language arguably overturns the provision in the JOBS Act that requires issuers to take "reasonable steps" to ensure accredited investor status.

Nor does self-certification ensure that investors are in fact registered representatives, investment adviser representatives, lawyers, or CPAs. There are a number of reasons why individuals might incorrectly certify their status. They may be mistaken about their current status. Investors may misrepresent their status in order to participate in what looks like an attractive offer. [37] They may also do so at the instigation of a third party [38] or as a result of fabrication by a third party.[39]

It should also be noted that at least for some of the categories referenced in the legislation, verification is not difficult. The status of registered representatives and investment adviser representatives can be easily ascertained in existing and accessible data bases.[40]

3. Retention and Use of Services

HR 2187 would also permit persons to certify that they have retained a broker, adviser, attorney or CPA and "used the services . . . to make an investment decision relative to the securities being offered". This provision allows unsophisticated investors to qualify as accredited simply by retaining a professional and using the professional's services in connection with the investment. The language, however, raises a number of concerns.

First, the language of the provision is unclear. It does not explicitly provide that the professional must have been retained to provide investment advice with respect to a particular security. A lawyer providing estate planning or a CPA reviewing a tax return could provide "services" related to an investment without actually providing investment advice.

[37] *See* Markup of H.R. 2940, Access to Capital for Job Creators Act, Subcommittee on Capital Markets and Government Sponsored Enterprises, House Financial Services Committee, 112th Cong. (Oct. 5, 2011) (remarks of Representative Waters) (Nov. 3, 2011) ("there will be no reason to believe that any investor seduced by public advertising will hesitate to be dishonest with completing the investor suitability questionnaire").
[38] *See In re Sabado*, Securities Act Release No. 9238 (July 14, 2011) (allegations broker "instructed" investor to represent himself as accredited "when he was not.")
[39] *See In re Bettiga*, Securities Act Release No. 7553 (admin proc. July 9, 1998) (allegations subscription agreements falsified "in order to qualify [investors] as accredited investors by adding a fictitious asset to their financial information."); *In re Kaechelle*, Securities Act Release No. 7148 (March 8, 1995) (allegations that employee "permitted . . . salesmen and other employees to fabricate investor accreditation information"); *In re Henry*, Exchange Act Release No. 40183 (admin proc July 9, 1998) (allegations that by "falsifying the customers 'net worth' on these documents, the two registered representatives . . . qualified non-accredited investors as accredited investors."); *In re Dominion Capital Corp.*, Securities Act Release No. 7683 (admin proc May 13, 1999) (allegations that "representatives submitted false, inflated statements of customers' net worth on new account forms and subscription agreements . . . in order to qualify numerous customers to purchase these LLC interests. ").
[40] For a discussion of these data bases, see https://www.sec.gov/spotlight/investor-advisory-committee-2012/backgroundcheck-recommendation-april2-2015final.pdf

Second, the provision does not include a requirement that the professionals have any particular understanding or knowledge with respect to the investment at issue.

Third, the provision does not include any disqualifications for market professionals who have been determined to be bad actors.[41]

Fourth, the provision relies on self-certification by the investor. As discussed above, such information may be inaccurate. Moreover, an investor may not have been correctly informed as to the status of the person offering the financial product.[42]

Fifth, under the language, customers of brokers and advisers may become accredited simply as a result of receipt of investment recommendations. This would arguably be the case even where the broker or adviser knew that the investor lacked the sophistication needed to understand the investment.

Sixth, the provision does not include any prophylactic safeguards designed to ensure that investors are adequately protected in their relationship with the relevant professional. The definition of Purchaser Representative in Rule 501 requires that the representative have sufficient knowledge and experience about the prospective investment. There must be a written acknowledgement of a representative's status. Purchaser representatives must disclose certain conflicts of interest. None of these safeguards are required in the current draft.

Finally, the categories included in the legislation provide investors with different types of duties. Brokers, for example, are subject to suitability requirements while advisers have fiduciary duties. In the context of the sale of unregistered shares, individuals obtaining accredited status solely as a result of a recommendation from a retained market professional should receive a consistent and high standard of care. Such professionals should, therefore, be subject to a uniform fiduciary obligation.

4. Testing

HR 2187 would require the SEC to establish criteria for the use by FINRA "in administering an exam to license as accredited investors natural persons who don't meet the income and net worth requirements". The criteria "may include methods for assuring that

[41] *See* Rule 506(d), 17 CFR 230.506(d) (defining bad actor standards).

[42] *SEC v. Dodge*, Litigation Release No. 21759 (WD TX Dec. 1, 2010) (allegations in the complaint that individual "misrepresented that he was a licensed securities broker and that he had verified the validity of the Private Placement program."); *SEC v. Clifford*, Litigation Release No. 20622 (D. Mass. June 18, 2008) (allegations in the complaint that individual misrepresented that he was a "registered investment advisor[]" and was "affiliated with a particular registered investment adviser/broker-dealer when he was not"); *In re Robert A. Tommassello*, Exchange Act Release No. 51587 (admin proc. April 21, 2005) (allegations that individual "misrepresented to investors [that corporation was] a registered investment adviser.'"). *See also* https://www.finra.org/investors/alerts/cold-calls-brokerage-firm-imposters%E2%80%94beware-old-fashioned-phishing ("Recently, FINRA has received reports that scamsters are posing as employees of at least one well-known brokerage firm to obtain personal information. In a new twist to Internet "phishing schemes," which use spam email to lure you into revealing everything from Social Security numbers to financial account information, it appears that some fraudsters may be resorting to a time-tested method—the telephone call.").

licensed accredited investors demonstrate a competency in understanding" including the following:

A. The different types of securities.
B. The disclosure obligations under the securities laws of issuers versus private companies.
C. The structures of corporate governance.
D. The components of a financial statement.
E. Other criteria the Commission shall establish in the public interest and for the protection of investors.

Testing is an appropriate method of determining sophistication. The test needs to be thorough and robust and administered by the proper agency or entity.[43] It also needs to have a temporal component that requires retesting or at least additional testing after a defined period of time. An investor who passes the test at age 25 may not have an adequate understanding of the risks associate with the market 50 years later.

The list of tested factors should also be expanded. Other possible topics include: (1) market structure, such as the role of brokers, advisers and other financial professionals (2) the principal factors affecting securities markets and prices, whether bonds or equities; (3) an understanding of primary and secondary offerings, including restrictions on resales and consequences of illiquidity; (4) the traditional risk profile for particular types off investors, particularly those with retirement plans and other tax advantaged accounts; (5) an understanding of collective investment vehicles such as closed end funds, real estate investment trusts, hedge funds, and, blind pool/ blank check companies; and (6) the common factors that suggest a heightened risk of securities fraud.

D. The Ongoing Process

As required by Section 413 of Dodd-Frank,[44] the staff at the Commission is working on a study of the definition of accredited investor with respect to individuals with the goal of determining whether adjustments should be made.[45] Changes must be "appropriate for the protection of investors, in the public interest, and in light of the economy." Commentators have had a chance to weigh in the process and provide their views.[46]

The staff likely has under review all aspects of the definition, including both the dollar thresholds and the need to add categories of individuals who are sophisticated in fact. The SEC

[43] FINRA has experience administering tests to market professionals rather than investors.
[44] *See* Net Worth Standard for Accredited Investors, Securities Act Rel. No. 9287, at 5-6 (Dec. 21, 20 II) ("Section 413(b) specifically authorizes us to undertake a review of the definition of the term 'accredited investor' as it applies to natural persons, and requires us to undertake a review of the definition in its entirety every four years, beginning four years after enactment of the Dodd-Frank Act. We are also authorized to engage in rulemaking to make adjustments to the definition after each such review."), *available at* http://www.sec.gov/rules/final/2011/33-9287.pdf
[45] Speech by Commissioner Piwowar, supra ("I welcome this review, and am pleased that staff in our Division of Corporation Finance is currently working on the study.")
[46] *See* http://www.sec.gov/comments/jobs-title-iv/jobs-title-iv.shtml; *see also* https://www.sec.gov/comments/s7-06-13/s70613.shtml

is, therefore, in a position to engage in a holistic, thoughtful reevaluation of the definition that takes in to account all of the competing interests. The results will presumably be made public and presumably generate proposals for reform of the accredited investor definition. Any legislative revisions should be delayed at least until the completion of this process.

II. Business Development Companies

Business development companies were created to "make capital more readily available to small developing and financially troubled businesses."[47] To accomplish this task, BDCs can only invest 70% of total assets in securities of certain types of companies ("eligible portfolio companies"). Excluded from this definition are investment companies and companies set out in Section 3(c) of the 1940 Act.[48]

Among other things, proposed revisions would reduce the asset coverage for senior securities representing indebtedness from 200% to 150%, permit multiple classes of preferred shares, and alter the definition of eligible portfolio company to permit an increase in investments in non-operating companies. Finally, discussion has occurred over the authority of commercial banks to sponsor BDCs under the Volcker Rule.[49]

Some of the proposed revisions, such as the reduction in the asset coverage for senior securities, appear to be appropriate reforms designed to allow BDCs to have some additional capacity to raise funds. Such a change will potentially increase the risks associated with a BDC. Nonetheless, this is one area where adequate disclosure to investors appears to be a reasonable method of addressing the concern. In addition, the draft legislative proposal provides investors with an opportunity to exit the company before the new limits become applicable.

The draft legislative proposal would also allow for the issuance of multiple classes of preferred shares. In doing so, the proposal would eliminate a number of investor protections currently in the statute. These include the right of preferred shares to elect at least two directors or, in some cases, the entire board. Likewise, the legislation would eliminate the right of shareholders to approve a reorganization that adversely affected such securities. The provision also provides that preferred shares need not have voting rights or equal voting rights.

The elimination of these protections is ameliorated by a provision in the current draft that provides that changes shall not apply to stock "issued to a person who is not known by the company to be a qualified institutional buyer". The provision therefore ensures that only very sophisticated purchasers will acquires these shares from the BDC. It should be noted, however,

[47] Investment Company Act Release No. 27538 (Oct. 25, 2006).
[48] Section 2(a)(46) of the Investment Company Act of 1940; *see also* Section 3(c) of the Investment Company Act of 1940.
[49] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536, 5675 (Jan. 31, 2014) ("The Agencies do not believe it would be appropriate to treat as a covered fund registered investment companies and business development companies, which are regulated by the SEC as investment companies.").

that the provision appears to be limited to shares issued by the BDC and does not appear to apply to resales.

The provision does, however, provide discretion that at least in some cases can disadvantage the common stockholders. By eliminating the need for voting rights or "equal voting rights with every other outstanding voting stock" the provision does not prohibit super-voting shares (shares with more than one vote per share).[50] A BDC could conceivably issue a new class of preferred shares that transfers voting control to the owners of that class. Moreover, new classes or series of preferred shares can typically be issued by the board of directors, without shareholder approval.[51] Perhaps the provision could be changed to provide that the provisions of Section 18(i) of the 1940 Act would only be inapplicable with respect to voting rights to the extent that voting rights are equal to or less than the voting rights of the common shares.

Perhaps the most serious concern posed by this draft legislation is the proposed change in the definition of eligible portfolio company. The legislation would allow BDCs to increase the percentage of assets that can be invested in financial firms. When adopted in 1980, Congress deliberately sought to increase funding to operating companies rather than financial firms.[52] The purpose was to protect a class of companies considered critical to the US economy. As the House Report stated:

> The Committee is well aware of the slowing of the flow of capital to American enterprise, particularly to smaller, growing businesses, that has occurred in recent years. The importance of these businesses to the American economic system in terms of innovation, productivity, increased competition and the jobs they create is, of course, critical. Hence, the need to reverse this downward trend is of compelling public concern.

H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20 (1980). Congress sought to provide assistance both by increasing the amount of capital available to eligible operating companies and by requiring that the BDCs offer them "significant managerial assistance."[53]

Changing the definition of eligible portfolio company to permit increased investment in financial firms may result in a reduction in the funds available to operating companies. It may also result in an increase in the cost of funds to operating companies. To the extent that

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[50] Section 18(i) of the 1940 Act.
[51] The authority to do so is commonly found in the articles. For an example of this authority, see *GOLDMAN SACHS BDC, INC.*, Article IV, Certificate of Incorporation, *available at* http://www.sec.gov/Archives/edgar/data/1572694/000119312515074210/d838148dex99a.htm
[52] *See* Small Business Investment Incentive Act of 1980, HR Rep. No. 96-1341, 96th Congress, 2d Sess. 29 ("This requirement ensures that the business development company will invest in operating companies rather than investing in other financial institutions. For example, an eligible portfolio company could not be a broker, bank or insurance company."); *see also id.* at 61 ("Unlike most registered investment companies, business development companies frequently have control of the operating companies in which they invest. This section makes clear that control, in and of itself, does not serve to bring those operating companies within the purview of the Investment Company Act.").
[53] 15 USC 80a-2(a)(47). This can include any arrangement whereby the BDC provides "significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company". *Id.*

operating companies incur a reduction in financing from BDCs, they will also not benefit from the obligation to provide significant managerial assistance.

With respect to the decision by commercial banks to form BDCs, this has the capacity to impact the market occupied by BDCs. Even with a limit in the number of shares that a commercial bank is likely to own,[54] the market may perceive the credit of a bank sponsored BDC as superior to at least some of the other BDCs, perhaps even as implicitly guaranteed. Any funding advantage could, as a result, allow bank sponsored BDCs to increase their market share.[55]

[54] To avoid treating the BDC as an affiliate, banks may not "own, control, or hold with the power to vote 25 percent or more of the voting shares" of a BDC. *See* 12 CFR §248.12(b) Permitted investment in a covered fund

[55] For an article addressing the competitive advantages of commercial banks in other contexts, see J. Robert Brown, Jr., *The "Great Fall": The Consequences of Repealing the Glass-Steagall Act*, 2 Stanford J. L., Bus. & Fin. 129 (1995), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=961634

Hearing on "Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities"
House Committee on Financial Services
Subcommittee on Capital Markets & Government Sponsored Enterprises
June 16, 2015

Testimony by Vincent D. Foster
Chairman of the Board, President and Chief Executive Officer
Main Street Capital Corporation
On behalf of the Small Business Investor Alliance
www.SBIA.org

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Good Afternoon Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee on Capital Markets and Government Sponsored Enterprises. I appreciate the opportunity to testify today on behalf of the Small Business Investor Alliance (SBIA), which represents a significant proportion of the Business Development Company (BDC) industry. SBIA's BDC members provide vital capital to small and medium sized businesses nationwide, resulting in job creation and economic growth. Since our organization was established in 1958, our mission has been to ensure a healthy and vibrant market for small and mid-size businesses.

Background on Main Street Capital

My name is Vince Foster and I am the Chairman, President, and CEO of Main Street Capital Corporation (Main Street), a SEC-registered Business Development Company (BDC) based in Houston, Texas. Main Street is publicly-traded on the New York Stock Exchange (NYSE: MAIN) and is currently the 6th largest BDC by market capitalization and assets. Since our IPO in 2007, we have invested more than $4 billion in more than 400 small and mid-sized companies: in the process, creating or retaining many jobs and providing capital to growing businesses that were unable to access capital through commercial banks or other traditional financing sources.

At Main Street, our primary focus is providing long-term debt and equity capital to private U.S. companies operating in what we refer to as the lower middle market. We also provide debt capital to middle market companies. Our portfolio investments are typically made to support management buyouts, recapitalizations, growth financings, refinancings, and acquisitions of companies that operate in diverse industry sectors. We seek to partner with entrepreneurs, business owners, and management teams and, generally, provide "one stop" financing alternatives within our lower middle market portfolio. Our lower middle market companies have annual revenues between $10 million and $150 million, while our middle market debt investments are made in businesses that are generally larger in size than our lower middle market portfolio companies.

We currently have investments in 70 lower middle market companies, nearly all of which include debt and equity investments which comprise roughly half of our investment portfolio. Over half of these lower middle market companies have annual revenues less than $25 million, and our average equity ownership position in our lower middle market investments is 36%. Since the mid-1990s, we, through Main Street and its predecessor funds, have founded, purchased, or financed lower middle market investments in over 200 companies in numerous industries.

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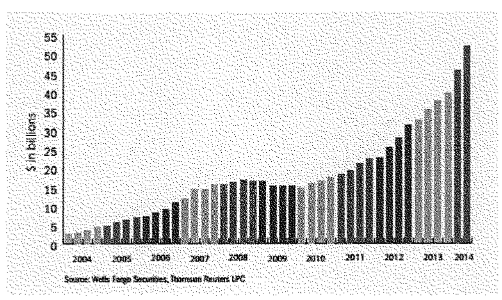
<u>The BDC Sector is Growing and BDCs are a Positive Force in Providing Capital to Small and Mid-Size Businesses</u>

BDCs were created by Congress in 1980 to enhance capital access to small- and medium-sized businesses and to create the opportunity for the general public to get access to private equity and venture capital-like returns. BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to rely on accessing capital from traditional sources such as banks. Pursuant to applicable regulations, BDCs are required to invest at least 70% of their assets in small- and medium-sized U.S. operating businesses (eligible portfolio companies). For most BDCs, the percentage of eligible portfolio companies is well above 70%.

Despite an outdated regulatory regime which has been in place since the early 1980s, the number of BDCs has grown significantly since 2004. This growth accelerated following the downturn of the economy experienced after the 2008-2009 economic recession, where BDCs provided a significant source of capital for small and mid-size businesses that were starved of capital. Currently, there are over 80 BDCs in the United States and BDC loan balances have more than tripled since 2008. The chart below shows the rapid growth of exchange-traded BDC loan balances since 2010, illustrating the significant growth in BDC lending to middle market companies and the strong interest of investors to participate in this space.

Estimated Publicly Traded BDC Loan Balances (Nov. 2014)



BDCs have various investment strategies, including providing flexible debt and equity solutions to small and mid-size companies. BDCs typically make secured and unsecured loans between $10 and $50 million to middle market companies, returning strong returns to their shareholders.

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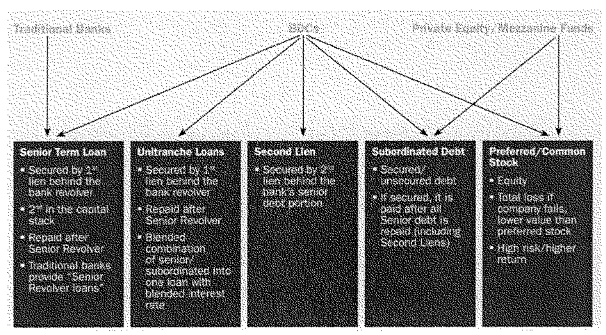
This financing helps small and mid-size businesses create jobs and finance new capital projects such as land, equipment, and factories. At the same time, average Americans are able to invest in these BDCs and earn healthy returns in their investment portfolios.



<u>Main Street Investments Across the United States</u>

Our lower middle market portfolio companies operate across many diverse industry groups and are headquartered in 24 different states. To illustrate this diversity: we have funded two of the fastest growing technology companies in Eugene, Oregon; the largest privately-owned jewelry store chain in the Rocky Mountains, headquartered in Twin Falls, Idaho; one of the largest Goodyear tire retailers in the U.S., headquartered in Austin, Texas; the leading micro-irrigation design and installation company in the San Joaquin valley in central California; the leading FBO at the Indianapolis airport; one of the largest fully integrated precast concrete companies in Texas, headquartered in San Antonio; and one of only two independent synthetic rubber producers of Styrene-Butadiene-Rubber (SBR) in the U.S., headquartered in Baton Rouge, Louisiana, just to name a few.

We note that the Committee's membership is currently represented by 24 states. As of today, we have investments in lower middle market businesses headquartered in 15 of these states. These investments generally consist of both debt and equity in each company, which would not otherwise be available from traditional sources such as local commercial banks or traditional private equity funds. These companies range from GRT Rubber Technologies (www.grtrubber.com) in Paragould, Arkansas, which was founded in the 1880s and

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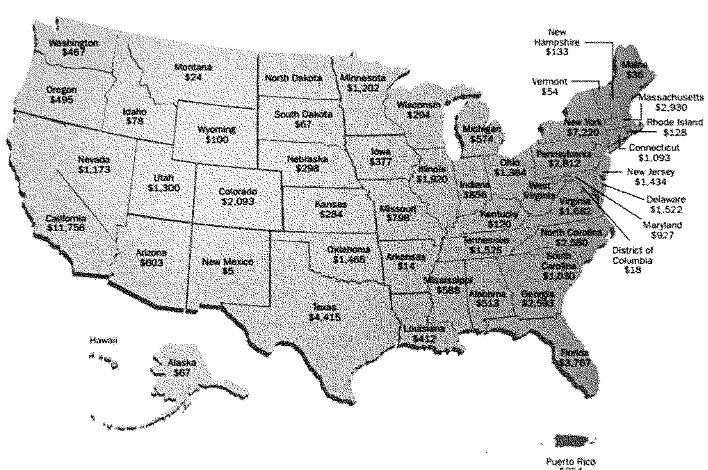
manufactures engineered rubber products including conveyor belts; to Bridge Capital Solutions (www.bridgecapitalsolutionscorp.com) in Hauppauge, New York, which operates Long Island's only licensed commercial check cashing service, serving small businesses in New York.

BDCs have provided significant investment to small and mid-size businesses across the United States, in almost every state, as illustrated in the map below.

State by State BDCs Total Exposure (in Millions)



Data Provided by Wells Fargo Securities, LLC

BDCs are Highly Regulated and Provide Transparency to Investors

BDCs are heavily regulated by the Securities and Exchange Commission (SEC or Commission). When BDCs were created in 1980, they were placed in a unique and somewhat unwieldy structure of being governed like a mutual fund through the Investment Company Act of 1940 ('40 Act), while also having many requirements imposed on them similar to operating companies (such as making periodic 10-Q and 10-K filings with the Commission). Under the '40 Act, BDCs must offer to provide significant managerial assistance to the companies they invest in, helping

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these small and mid-size companies improve their products and grow their businesses. Unlike a mutual fund, BDCs are generally not buying publicly traded stocks, but are instead investing in largely illiquid small- and medium-sized businesses. With this in mind, BDCs are active participants in providing non-financial resources to help their investments grow.

BDCs are extremely transparent in their operations and investments. The public can readily look up all of the investments that a BDC has made. BDCs must register their shares with the SEC and engage in lengthy, transparent, and significant disclosure on their operations and investment activities to ensure their investors are fully informed. BDCs, through the filing of registration statements and periodic public filings (8-K, 10-K and 10-Q) with the Commission, make significant disclosures about their business operations, leverage loads, and the investments they make – informing shareholders about the types of investments and loans they are making to these small and mid-size businesses, allowing them to make an educated decision on whether to invest.

While BDCs have extensive oversight and disclosure requirements, providing clarity and transparency for investors, the current regulatory regime for BDCs is outdated and unnecessarily burdensome. These burdens make the BDC capital raising process less flexible, less efficient, and more expensive than necessary, while providing little improvement to investor protection or additional transparency as a result. Modernizing BDC regulations will help support American jobs and foster economic growth by improving access to the public capital markets for BDCs. It will also free up significant resources at the SEC, which can be utilized more effectively to protect investors. The goal is an efficient regulatory system that maintains investor protections.

In late 2005, the Commission implemented a significant "Securities Offering Reform" which was a sweeping modernization of the registered offering process and rules for public companies. Unfortunately, there was no voice for the few BDCs in the market at the time and reforms were not applied to BDCs. This left BDCs on an uneven playing field with other public companies seeking to access the capital markets. The SEC has failed to modernize the rules for BDCs despite a call to action by the BDC community on numerous occasions, most recently in an October 2013 letter from 24 BDCs spearheaded by SBIA. As a result, the industry is seeking Congressional help to provide BDCs the same offering rules as other public companies.

SBIA's Comments on the Discussion Draft of "The Small Business Credit Availability Act"

I would like to thank the Members of the House Subcommittee on Capital Markets and Government Sponsored Enterprises for working in a bipartisan manner to produce a discussion draft on BDC legislation, entitled the "Small Business Credit Availability Act." I want to especially thank Chairman Scott Garrett, Congressman Mick Mulvaney (R-SC), and Congresswoman Carolyn Maloney (D-NY) for their efforts.

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My comments are representative of the SBIA membership which consists of over 30 BDCs investing across the country. The purpose of the legislation is to improve the ability of BDCs to fulfill their core mission of providing necessary capital and expertise to small and mid-size companies. The legislation makes a number of significant and necessary changes to modernize the regulation of BDCs and increase access to capital while continuing to preserve investor protections. The discussion draft has made a number of improvements from previous legislation and addressed issues that have come up in previous testimony. The discussion draft is a strong step in the right direction and we appreciate the opportunity to work with you to improve and finalize this legislation to ensure it is worthy of a timely markup and passage.

The Committee Should Adopt the Necessary Changes to Streamline BDC Offering and Proxy Rules in Section 4 of the Discussion Draft

Section 4 of the *Small Business Credit Availability Act* amends the '40 Act and certain other SEC rules and regulations to make necessary changes to streamline the offering, filing, and registration processes for BDCs at the SEC, eliminating unnecessary regulatory burdens, and providing offering standards consistent with other traditional public companies. The offering, filing, and registration reforms are particularly imperative for smaller BDCs, which will pay disproportionately higher costs to handle the enormous amount of paperwork required under the current BDC regulatory regime. It is extremely important for small BDCs to have a streamlined, efficient regulatory regime that removes unnecessary compliance costs and focuses the BDCs attention on investing in small and mid-size companies across the country.

The reforms to the offering and proxy rules in this Section contain over a dozen important regulatory reform changes that will save firms hundreds of thousands of dollars, streamline the offering process to make it faster and more efficient, and improve the ability of investors to access information and research from BDCs and independent parties. For example, this legislation allows BDCs to utilize "incorporation by reference," which allows them to cite information in previous filings, rather than having to include the exact same information again in a new filing. This provision will streamline disclosure requirements and reduce burdensome, duplicative regulatory paperwork for BDCs, while still ensuring investors receive the relevant and necessary disclosures. Investors would benefit from having a streamlined filing to review, rather than sifting through hundreds of pages of duplicative information.

Another important provision from Section 4 would allow BDCs to file automatic shelf registration statements and permit BDCs to qualify for Well Known Seasoned Issuer (WKSI) status. These changes will permit BDCs that have a lengthy track record in the marketplace, and the confidence of investors, to offer their securities with more flexibility and efficiency to shift with market demands and changes. Furthermore, these changes to the regulations would eliminate the requirement for BDCs to mail lengthy prospectuses to investors and elect to only

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send these documents when investors wish to receive them. This is a common-sense solution that will save thousands of dollars in delivery costs, and save investors from having to accept lengthy documents that they may never intend to read. The changes in Section 4 are critical for investors and BDCs alike and should be included in any final bill that is introduced during this Congress.

The Committee Should Adopt Provisions in the Discussion Draft that Expand Access to Capital for BDCs

Section 3 of the *Small Business Credit Availability Act* will provide BDCs the option to deploy significantly more capital to small- and medium-sized businesses by changing what is known as the "asset coverage ratio." BDCs are currently limited to a 1:1 debt-to-equity ratio as opposed to banks and other financial vehicles that are often leveraged at a 9:1 ratio or higher. Allowing a the option for a modest increase in this leverage to 2:1 would enable BDCs to deploy significantly more capital to small and mid-size businesses. Simultaneously, BDCs will be able to reduce the risk in their portfolios, as they can invest in lower yielding, lower risk investments and still generate valuable returns and dividends to their shareholders. To be clear, this provision does not automatically increase leverage. It gives BDCs a regulated option to pursue increased leverage, but subject to investor protections and market constraints.

We believe the provisions in the legislation add new safeguards for BDC investors and ensure that investors will be sufficiently informed about leverage levels BDCs are taking on. The discussion draft provides *two options* for BDCs to increase their leverage. Under the *first* option, the BDC may conduct a vote of their Board of Directors, including the independent directors, with a 12 month waiting period after this vote. After 12 months, the BDC may access the increased leverage. Under the *second* option, the BDC may elect to conduct a shareholder vote. The vote may be held at an annual or special meeting, there must be a quorum, and more than 50% of shareholders must vote in favor of the increased leverage. After the vote on the second option, the BDC may access leverage immediately. If a BDC wishes to utilize the *first* option and is non-listed (i.e., not traded on a national stock exchange), it must provide a redemption facility to allow those investors to exit the BDC if they choose, at a reasonable price.

This process is well tailored in that it provides adequate time and means for BDC shareholders to exit or sell their shares in the BDC, or the ability to vote on the leverage change. Additionally, BDCs must notify the SEC and investors by filing an 8-K within five days of the board vote, place a public notice on the BDC's website, and disclose in their periodic filings that the change to the asset coverage ratio has been approved. These are meaningful investor protections and we support their inclusion.

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The Committee Should Retain the Ability for BDCs to Own Investment Advisers in the Legislation

Section 2 of the *Small Business Credit Availability Act* makes a variety of changes that expand the flexibility of the types of companies in which BDCs can invest. The first change permits BDCs to own or acquire securities or other interests in registered investment advisers or other advisers to investment companies. The SEC has routinely provided no-action or exemptive relief to BDCs, including to Main Street, by permitting the ownership of investment advisers, thereby avoiding the BDC itself from having to serve as an investment adviser in a particular investment. Given the pervasiveness of SEC relief, this provision will standardize the practice and significantly increase the transparency afforded to investors in BDCs. It will also reduce the burden on SEC staff and resources in responding to relief requests by BDCs, a significant burden due to this rapidly growing industry.

Expanding "Eligible Portfolio Companies"

BDCs must invest at least 70% of their investments in "eligible portfolio companies." Generally, these are operating companies and the types of businesses BDCs were created to help. The legislation will expand the definition of eligible portfolio companies to include new companies previously excluded from the definition. The legislation places a 50% cap of BDC total assets on these new eligible portfolio companies.

Upon release of the discussion draft, SBIA shared the language with its members as well as with shareholders and analysts who cover the BDC sector. This language reflects improvements over similar legislation that was introduced in previous years. Unlike the previously mentioned reforms that had overwhelming consensus and support, this expansion is generally not a priority for most SBIA members. For those that are most interested, there are very differing views on the merits. Having only had the discussion draft for a few days, the closest thing to uniformity on this issue is that this section should be modified and tightened. With a little more time to contemplate the long term impacts on the industry and to hear their investors' thoughts on the proposal, there will be greater consensus from BDCs that we will promptly share with the Committee. We look forward to working with the Committee to offer a workable adjustment to this provision quickly to help BDCs maintain a healthy market and continue to serve their mission and policy mandate.

Closing Remarks

I want to share the sentiments of many in the BDC industry by thanking the Committee again for holding this hearing, and I am encouraged by the bi-partisan efforts in moving forward this

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legislation. The Committee should act as soon as possible to pass these needed reforms to improve the capital formation process for BDCs and by doing aid small- and medium-sized businesses. We stand ready to answer any questions you have and to be a resource for you and your staff as you work out the final language of the *Small Business Credit Availability Act*.

Biography of Vincent D. Foster

Vincent D. Foster has served as Chairman and CEO of Houston-based Main Street Capital Corporation (NYSE:MAIN) since its IPO in 2007 and as its President since 2012. He has also been a member of Main Street's Investment Committee since its formation in 2007 and a member of its Credit Committee since its formation in 2011. Main Street is a Business Development Company focused on providing debt and equity capital to middle and lower middle market U.S. companies. Its investment operations include two Small Business Investment Companies, which are licensed by the U.S. Small Business Administration (SBA), and it has capital under management of $3 billion. Main Street was awarded the "2011 Small Business Investment Company of the Year" by the SBA. Main Street, under Mr. Foster's leadership, operated several investment funds prior to its IPO dating back to the mid-1990's.

Mr. Foster serves on the boards of Houston-based Quanta Services, Inc. (NYSE:PWR) and Sugar Land, Texas-based Team Industrial Services, Inc. (NYSE:TISI). Quanta Services, co-founded by a predecessor Main Street fund, and an S&P 500 Company, is a leading provider of specialized contracting services, delivering infrastructure solutions for the electric power and oil and gas industries in North America and internationally. Mr. Foster served as Quanta Services' Chairman from its founding in 1997 until 2002, and serves on its Audit and Investment Committees. Team Industrial Services is a leading provider of industrial services related to the maintenance and installation of pressurized piping systems and processes and inspection. Mr. Foster serves as Chairman of Team Industrial Services' Audit Committee.

Over the last 15 years, Mr. Foster served on numerous other public and private company boards of directors and co-founded the Houston Chapter of the National Association of Corporate Directors, serving on its board from 2004-2011.

Prior to his association with Main Street, Mr. Foster, a CPA, had a 19 year career with Arthur Andersen, including 9 years as a partner of Andersen Worldwide. Mr. Foster directed Andersen's Corporate Finance and Mergers and Acquisitions practice for the Southwest U.S.

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Mr. Foster was recognized for the Ernst & Young Entrepreneur of the Year 2008 Award in the financial services category in the Houston & Gulf Coast Area. The program honors entrepreneurs who have demonstrated exceptionality in innovation, financial performance and personal commitment to their businesses and communities.

Mr. Foster graduated from Michigan State University in 1978 where he earned his bachelor's degree in Business Administration (majoring in Accounting). He also earned a JD degree from Wayne State University Law School.

SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

HEARING ON: "LEGISLATIVE PROPOSALS TO MODERNIZE BUSINESS DEVELOPMENT COMPANIES AND EXPAND INVESTMENT OPPORTUNITIES"

JUNE 16, 2015

TESTIMONY OF

MICHAEL F. GERBER
EXECUTIVE VICE PRESIDENT
FRANKLIN SQUARE HOLDINGS, L.P.

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.

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[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.

[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-

[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.

Offering and Proxy Rule Reforms

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.

Additional Provisions

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.

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[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.

Statement of the U.S. Chamber of Commerce

ON: Examining Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities

TO: House Committee on Financial Services, Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness

DATE: June 16, 2015

1615 H Street NW | Washington, DC | 20062

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96 percent of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney and members of the Capital Markets and Government Sponsored Enterprises subcommittee. My name is Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector, and region. I appreciate the opportunity to testify before the subcommittee today on behalf of the businesses the Chamber represents.

Before I address the subject of the hearing, I would like to thank Chairman Garrett, Ranking Member Maloney and the members of the Capital Markets and Government Sponsored Enterprises for your continued laser focus on removing obstacles that prevent businesses from accessing the capital needed to grow and create jobs. These efforts to improve the efficiency of capital markets balanced with investor protections are the necessary building blocks for the American economy to grow and compete in a global arena. This hearing is one of several that the Subcommittee has held this year on these important issues and can result in a bi-partisan package of bills that can become law. Accordingly, the Chamber is hopeful that the subcommittee can put together a JOBS Act 2.0 to help America's small and mid-size businesses grow and for more firms to become public companies. We stand ready to work with this subcommittee to make that effort a reality.

1. **Diversity and Access to Capital Needed for America to Compete in a Global Economy**

Earlier this year, the Chamber released a study by Professor Anjan Thakor of Washington University entitled, ***International Financial Markets: A Diverse System Is the Key to Commerce*** (the "Thakor Report").

Businesses need diverse forms of financing to support business operations provided by banking institutions, as well as non-bank market based financing. In studying this complex and growing global financial system, the Thakor Paper found the global financial system:

- Creates money and facilitates cross-border capital flows;
- Facilitates specialization and trade;
- Promotes global risk management for individuals and companies;

- Mobilizes resources, creates new resources and promotes economic growth by encouraging innovation;

- Promotes transparency by obtaining information for the evaluation of businesses and individuals leading to more efficient allocation of capital; and

- Increases the growth opportunities available to companies, entrepreneurs and individuals.

With diversity, the financial system is more efficient, more new companies are launched, the larger the number of publicly listed companies, the better overall management of risk and greater availability of consumer credit. In other words a diverse, well-developed and efficient system of capital formation is necessary for robust economic growth and increased employment.

Over the past several years we have seen our capital markets lose efficiency. At the same time, we have seen a reduction of traditional means of business financing and cash management. The Basel III Liquidity Coverage Ratio Rules, as one example, create disincentives for banks to accept business cash deposits, while reducing loans and cutting commercial lines of credit. Therefore, we are reducing the diversity needed for America to compete. Indeed, it should be noted that the European Union is exploring ways how they can expand non-bank forms of business financing.

Therefore, we need to work on how to make our capital markets efficient and stable, to provide our businesses with the ability to compete in a world where 95% of consumers live outside of our borders.

The bills before us today are an important part of the process started by the JOBS Act. With the JOBS Act, Congress helped to modernize existing regulations and establish new systems to provide the opportunities to allow Emerging Growth Companies ("EGCs") to grow into public companies. The different bills and legislative concepts that have been the subject of the previous hearings held by the Subcommittee this year build on the foundation of the JOBS Act. The proposals before us today continue that tradition and are important as they help small and mid-size businesses continue on the path to becoming EGCs.

2. Legislative Proposals

a. Small Business Credit Availability Act

I would like to address the draft bill proposed by Mr. Mulvaney entitled the Small Business Credit Availability Act.

Over the past several years, mid-size and small businesses have had a harder time accessing capital and the liquidity needed to grow and operate. While larger businesses can afford a higher cost of capital, others have been forced to find alternative means of financing. Since 2010, we have seen a large increase in financing to businesses, primarily mid-size firms, by Business Development Corporations ("BDCs").

BDCs are a unique form of financing, similar to private equity, venture capital or Real Estate Investment Trusts. They have become increasingly popular as the credit cycle and regulatory reaction to the financial crisis have made accessing debt financing more challenging. It is important to keep in mind that BDCs are open to retail investors and not just accredited investors. BDC's tend to have higher yields, but also greater risks than fixed-income products. Since the creation of the BDC in 1980, BDCs have been limited in their activities and have a large degree of regulatory oversight. This oversight can be direct as to BDC operations and investor protections, or indirect through the types of financing that BDCs can access to fund their activities.

In 2013, the Chamber testified in support of a number of bi-partisan bills that would have allowed for increased activities by BDCs. At the time the Chamber also called for the Securities and Exchange Commission ("SEC") to re-examine disclosures to ensure that investors are properly aware of the risks of investing in BDCs.

The Chamber supports the Small Business Credit Availability Act as it would allow BDCs to meet the growing capital needs of businesses and addresses some of the concerns raised during the 2013 hearing and by the SEC. The Small Business Credit Availability Act will allow BDCs to increase their activities while maintaining the historic levels of regulatory oversight and investor protection.

The Small Business Credit Availability Act would increase the capital available to BDCs and their ability to provide small and mid-size businesses with the funding needed to grow. For example, some BDCs could be treated as "well known, seasoned issuers" and thus be permitted to issue securities more quickly. BDCs would be able to use a modestly higher level of leverage, which would permit them to invest more capital to portfolio companies. BDCs would also have more flexibility in their investments.

The Chamber also believes that the trigger to ensure that regulatory action is taken in a timely manner is a creative way to give the SEC the opportunity to make the rules necessary to effectuate the legislation's intent. This will prevent an endless rulemaking cycle that may harm the benefits BDCs can provide to capital formation and investors. Therefore, we can avoid a re-run of the seemingly endless JOBS Act Regulation A implementation. The Small Business Credit Availability Act also gives the SEC rulemaking authority to craft disclosures of conflicts of interests and other rulemakings to promote investor protections.

Accordingly, we believe that the Small Business Credit Availability Act strikes the appropriate balance by:

- Giving BDCs the ability to become bigger market participants;
- Giving businesses new alternative means to raise capital;
- Giving the SEC the ability to oversee BDC activities to ensure certainty, efficiency and competition; and
- Providing the SEC with the ability to enhance investor protection and increase investor opportunity.

The Chamber supports the Small Business Credit Availability Act and hopes this hearing can be the first step towards it being enacted into law.

b. H.R. 2187 Fair Investment Opportunities for Professional Experts Act

The Chamber also appreciates the opportunity to testify on H.R. 2187, the Fair Investment Opportunities for Professional Experts Act.

Ensuring investors have the right to access suitable investment vehicles is critical for markets to operate efficiently. This provides certainty and allows investors to engage in a rational and meaningful decision-making process. This of course does not guarantee a return, quite the opposite. But it does allow people to use their capabilities—in terms of resources and sophistication—to make investments. If those preconditions are present, then businesses have the opportunity to try and raise capital in efficient, well-regulated markets.

Therefore, we believe it is appropriate to put in place requirements and tests that correctly define persons who have the sophistication to put their money in complex vehicles and have the ability to withstand loss. Traditionally, this has been done through asset and income tests and these are objective standards that have served well in determining who should be allowed the designation of accredited investors.

The Chamber believes that Mr. Schweikert has also identified an important issue, namely that one may not meet these objective tests but could still fit the criteria of a sophisticated investor. Such a person, in limited circumstances, could be considered an accredited investor. If that issue is addressed appropriately, more investors can access markets and the potential for capital formation for businesses can be expanded.

Presumably an individual who has met the educational and licensing requirements to sell securities and investments could be deemed to be of such a level of sophistication that they should be considered to be an accredited investor. This is also an objective test that could be easily codified. One option is to cap the level of investments such a person could make in complex instruments. This will allow individuals to become accredited investors concurrent with their actual financial ability to withstand losses.

While we understand the intent behind the creation of a test to determine the level of knowledge for an individual to be considered an accredited investor, we believe that it is important first to understand the characteristics and sophistication of what an accredited investor should be. This can give a better understanding of the requisite characteristics before authorizing a test. We believe that the bill should be amended to direct the SEC to study the issues and the necessary makeup of accredited investors and determine what innovative ways may be used to reasonably reassess these definitions and apply them in limited circumstances.

The Chamber is also concerned with section of the bill that allows the use of a financial intermediary to convey accredited investor status upon a natural person. It is important to remember that the accredited investor definition is used to create limits on activities to prevent unnecessary investor harm. This allows complex investments to be marketed and sold in manners appropriate to the sophistication and wherewithal of investors. This boosts capital formation by expanding the pool of investments that are well regulated and have certainty. This section of the bill may place an unsophisticated investor at risk while creating liability for financial intermediaries.

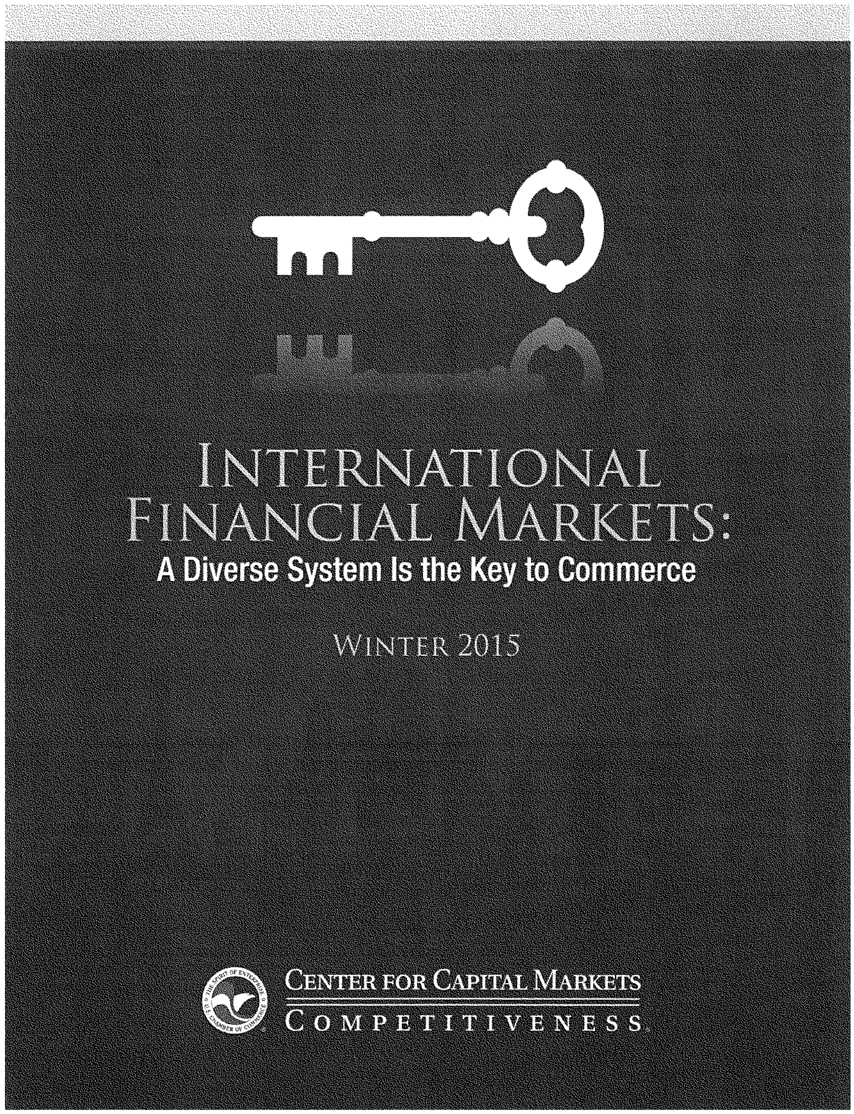
Again we believe that the Fair Investment Opportunities for Professional Experts Act is an innovative way to take a look at accredited investor definitions and responsibly expand them in a limited manner to bring more sophisticated investors into the marketplace. However, we believe that the changes we have suggested are necessary to prevent unsophisticated investors from being involved with products they don't understand. Also, our suggestions would allow the SEC to determine the right path forward and who should be eligible for a limited expansion of an accredited investor definition.

Without this adherence to investor protection, the capital markets may be harmed and the legislation not meets its true intent. We stand ready to work with Mr. Schweikert and the Subcommittee on this innovative bill to achieve a balance between the needs of potential sophisticated investors and investor protection.

3. Conclusion

The Chamber views these bills, along with our proposed improvements, as important steps to provide the diverse capital structure our free enterprise system needs and to allow for the dynamic changes the market place demands in order to provide the life blood necessary for entrepreneurs to start a business and for small and mid-size businesses to grow into larger ones. This has been the formula for success that has allowed the United States economy to grow at unprecedented levels throughout its history. These proposals are also needed for America to compete in a global economy. We believe that it is important for the Small Business Credit Availability Act and a modified form of the Fair Investment Opportunities for Professional Experts Act to be included in a JOBS Act 2.0 to provide American businesses with the capacity to access the resources needed to compete, thrive and create jobs.

I am happy to take any questions that you may have at this time.



INTERNATIONAL FINANCIAL MARKETS:
A Diverse System Is the Key to Commerce

WINTER 2015

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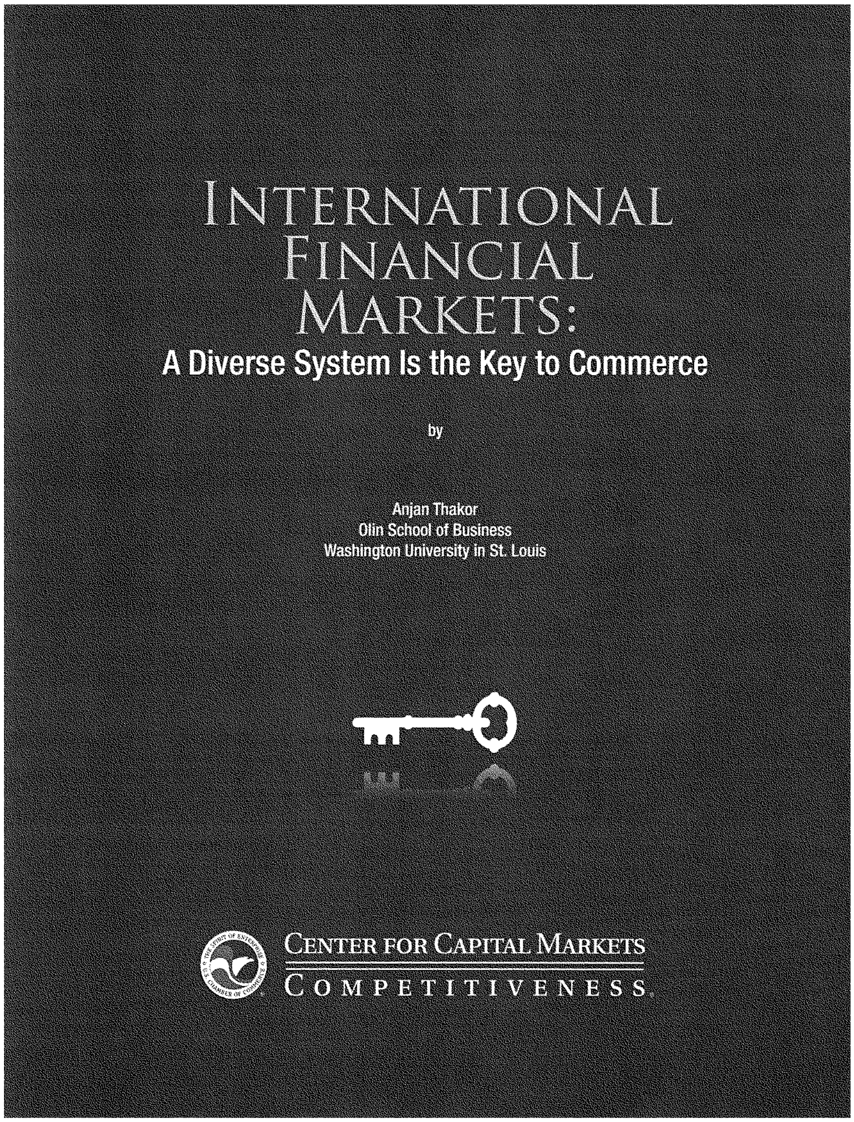

INTERNATIONAL FINANCIAL MARKETS:

A Diverse System Is the Key to Commerce

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INTERNATIONAL FINANCIAL MARKETS:

A Diverse System Is the Key to Commerce

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EXECUTIVE SUMMARY

This paper provides a broad overview of the global financial system. It describes how financial institutions and markets in various financial instruments make up the global financial system, and the size of this system. It also discusses how the global financial system helps to boost economic growth and facilitates global trade. Ten main conclusions emerge from this analysis.

First, the global financial system is vast and varied; it consists of many different types of financial institutions, as well as financial markets in stocks, bonds, commodities, and derivatives. The global capital market involves 46,000 traded stocks worth over $54 trillion. In 2012 the global bond market traded securities worth about $80 trillion, and the mutual fund industry traded about $26.8 trillion globally. Exchange-traded funds traded securities worth $2 trillion globally in 2012, and at the end of 2013 the total notional amount of over-the-counter derivatives was about $710.2 trillion globally.

Second, the global financial system promotes economic growth by:

- creating money and money-like claims;
- facilitating specialization and promoting trade;
- facilitating risk management, enabling individuals and firms to be insured against adversity in bad states of the world, thereby increasing investment and global economic growth;
- mobilizing resources globally and thereby improving the effectiveness with which local challenges are met;

- obtaining information for the evaluation of businesses and individuals and allocating capital, thereby overcoming problems of asymmetric information that make it difficult or costly for individuals and firms to obtain capital; and
- increasing the set of opportunities available to companies, entrepreneurs, and individuals to participate in and contribute to global economic growth.

Third, the global financial system is highly interconnected. This interconnectedness increases its complexity and the need for international harmonization of regulation. For example, if U.S. banks are subject to more stringent regulation than banks elsewhere, there may be incentives for banking activities to migrate to jurisdictions with less stringent regulation. But failures in those jurisdictions can have global impact due to the interconnectedness that exists within the global financial system.

Fourth, firms use the global financial markets to raise capital. The depth and liquidity of the global financial markets help companies reduce their capital costs, improve access to financing, invest more, and grow. This report examines case studies for Novo Industri, a Danish pharmaceutical firm, and Bunge, a global agribusiness firm headquartered in White Plains, New York.

Fifth, financial architecture refers to the composition of a country's financial system, in particular whether it is bank-dominated or market-dominated. Development of the financial system—regardless of whether it is bank-dominated or market-dominated—helps economic growth. However, market-dominated financial systems are better at promoting technological and financial innovations.

Sixth, the global financial system promotes global trade through financing mechanisms outside the banking system, such as trade credit. Trade credit is the extension of credit by a firm to its customers. Firms in more well-developed financial systems tend to use more bank debt relative to trade credit, and firms in less-developed financial systems use more trade credit. Thus, trade credit helps to make the global financial system more efficient by substituting for bank credit when such substitution is efficient. During 2005–11, global trade credit was approximately $1 trillion annually, and the availability of trade credit benefits "Main Street."

Seventh, large projects, including those for infrastructure, are often financed through private-public partnerships involving project financing. Power and transportation projects dominate this market, and private-public partnerships have been proven generally useful.

Eighth, banks as well as financial markets are regulated, and in both cases regulators face tensions in enforcing regulations that pull in opposite directions. Regulatory actions to achieve financial stability in the face of these tensions lead to greater interconnectedness in the financial system.

Ninth, bank regulation has multiple goals, and it is being increasingly harmonized, but the danger is that regulation may go too far. While regulation boosts economic growth to a point, beyond that point the costs to banks of complying with these regulations exceed the benefits to society. Thus, regulation beyond that point harms economic growth and employment. This is especially true when international regulators coordinate ineffectively and produce regulation in one jurisdiction that has ripple effects in other jurisdictions.

Finally, market-based financing, commonly know as shadow banking—financial intermediaries other than commercial banks (e.g., mutual funds, investment

banks, and hedge funds)—is growing more rapidly than traditional banking. By year-end 2011, this sector was $67 trillion globally. In the United States, market-based finance is twice as big as depository banking. Shadow banks provide firms and households with valuable economic services.

INTRODUCTION

The global economy is massive and growing. According to the World Bank, global Gross Domestic Product (GDP) had grown from $71.83 trillion in 2012 to approximately $74.91 trillion in 2013.[1] The United States accounted for over 22% of global GDP in 2013, but this percentage has been declining over time owing to the emergence of the economies in India, China, Brazil, and other developing countries. A sometimes overlooked factor in this global growth is that it is facilitated by ever-growing and increasingly complex economic interconnections between countries. Economist Frederick Hayek referred to this phenomenon as *Catallaxy*—specialization of tasks and functions that leads to the exchange of specialties among specialists and, consequently, economic growth. One can observe that Catallaxy is now occurring at the national level—some nations are specializing in fostering innovation in some industries, others are specializing in providing the infrastructure for large-scale manufacturing, and yet others are serving as hubs for the provision of services. The global flow of goods and services produced by this phenomenon is large. Manyika et al. (2014) report that the global flow of goods, services, and finance was almost $26 trillion in 2012, or 36% of global GDP that year. *Figure 1* shows the growth of these flows over time.

1. See World Bank (2014).

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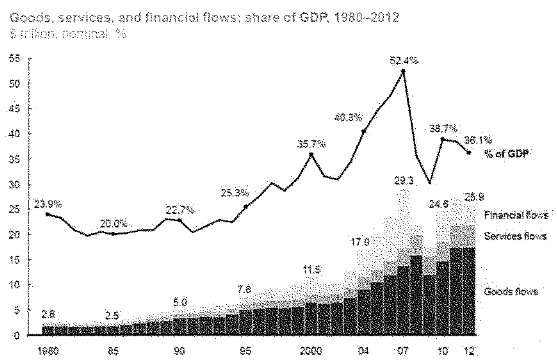
Figure 1. Traditional Flows of Goods, Services, and Finance Reached $25.9 Trillion in 2012



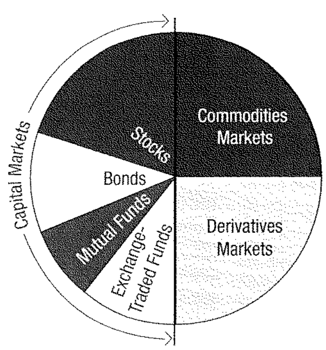
Source: *Comtrade; IMF Balance of Payments; World Trade Organization; McKinsey Global Institute analysis (Manyika et al., 2014).*

While such global flows increase the size of the global economic pie, they also engender greater interconnectedness among the financial systems of the world because an increasing share of global economic activity takes place across borders. The McKinsey Global Institute Connectedness Index measures the connectedness of 131 countries across all flows of goods, services, finance, people, and data and communication. It reflects the level of inflows and outflows adjusted for the size of the country. The data show that connectedness has been on the rise in most countries and that global *financial flows* accounted for almost half of all global flows in 2012. An important reason for this is the growing significance of the financial sector as a percentage of the overall economy in developed countries, and the development of financial markets in the emerging countries to support their rapidly growing economies and burgeoning trade flows.

This report examines how global financial flows promote economic growth and how the global financial system meets the needs of "Main Street." The related issues of the role played by global financial institutions, their central banks, and the interconnectedness of these banks and their international regulation are also discussed. Shadow banking is a consequential component of this discussion. The growth of shadow banking is one of the most striking developments prior to the financial crisis of 2007–09, and its significance is underscored by the fact that many financial flows now occur outside the traditional depository banking sector.

At a very basic level, the global financial market links savers to investors across national boundaries by offering investors a vast array of investment products across a dazzling variety of financial markets. We can think of the financial market as consisting of the capital markets, commodities markets, and derivatives markets. See *Figure 2* below.

Figure 2. Global Financial Markets



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The ***capital markets*** consist of the markets for stocks, bonds, mutual funds, and exchange-traded funds (ETFs). At the end of 2012, according to the Bank for International Settlements, over 46,000 stocks were traded globally, and the global market consisted of more than $54 trillion worth of traded stocks.[2] A ***stock*** is essentially an equity (or ownership) claim on the cash flows and assets of a company.

A ***bond*** is a debt security that represents a fixed-income claim on the cash flows and assets of a company. The global bond market was valued at about $80 trillion in 2012, in terms of the aggregate value of the bonds traded. That means the global bond market was about 50% bigger than the global stock market in 2012.

Mutual funds are pools of cash collected from investors and invested in diversified baskets of traded securities. The securities include stocks, bonds, and other money market instruments. Mutual funds provide a very convenient and low-cost way for investors to diversify their portfolios across numerous industries and firm sizes. They initially came into prominence in the United States during the 1980s to provide investors with a means to earn high returns at low risk because Regulation Q ceilings on deposit interest rates prevented investors from earing adequate returns on bank deposits during periods of high inflation. Although not insured by the government, mutual funds provided investors with low risk due to diversification, with returns that were 5%–7% higher than attainable on (insured) bank deposits in the 1980s. This resulted in large flows from insured bank deposit accounts into mutual funds and spurred the growth of the industry. Today that is no longer the dominant motivation for the existence of the industry, but it is an industry that has nonetheless grown worldwide. The Investment Company Institute estimates that in 2012 the mutual fund industry had assets of about $26.8 trillion globally, with the U.S. mutual fund market representing about $13 trillion of that amount.

2. See Huntsley (2014).

Exchange-Traded Funds provide many of the same benefits as mutual funds. An ETF tracks an index, a commodity, or a basket of assets like an index (mutual) fund, but unlike a mutual fund, it trades on an exchange like an individual stock. By owning an ETF, an investor can obtain the diversification benefits of an index fund and can also sell short, buy on margin, and purchase small quantities (e.g., one share). ETFs have been around only since the 1990s, but they have experienced explosive growth, with $2 trillion in assets as of year-end 2012.

Commodities markets offer investors the opportunity to invest in physical commodities. As such, they provide investors with diversification opportunities that go beyond those provided by the capital markets. About 50 major commodity markets exist worldwide, and they involve trade in about 100 primary commodities, including mined natural resources (gold, silver, oil, etc.) and agricultural products and livestock (soy, wheat, pork bellies, etc.). As of year-end 2011, commodity mutual funds—which provide investors with a way to invest in commodities without trading directly in the primary commodities themselves—had $47.7 billion in assets,[3] but this number is small compared with the size of global commodity markets. The monthly global trading volume in commodity futures and options markets as of year-end 2011 was almost $11 trillion, and the total annual global sales in the spot market stood at about $6.4 trillion.[4]

The *derivatives market* involves trade in *derivative contracts*. As the name suggests, these are financial contracts whose value is driven by the value of some other asset or security. Commonly used derivatives are forwards, futures, options, and swap contracts. The total notional amount of over-the-counter derivatives at the end of 2013 was about $710.2 trillion globally.[5]

3. See ICI Research Perspective (2012).
4. See ICI Research Perspective (2012).
5. See Bank for International Settlements (2014).

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GLOBALLY INTERCONNECTED FINANCIAL MARKETS FOSTER GLOBAL ECONOMIC GROWTH BOTH DIRECTLY BY FACILITATING TRADE FLOWS AND INDIRECTLY BY INCREASING THE WEALTH OF INDIVIDUAL INVESTORS.

The large magnitudes involved in global financial markets reflect, in some sense, both the desire on the part of investors to invest globally and diversify across a growing number of securities and the constantly rising global trade flows. Thus, globally interconnected financial markets foster global economic growth both directly by facilitating trade flows and indirectly by increasing the wealth of individual investors that then enables them to increase their demand for goods and services and thus contributes further to global economic growth. But how specifically does the global financial system promote economic growth on Main Street?

The global financial system promotes economic growth in six ways: (1) by creating money and money-like claims; (2) by facilitating specialization and promoting trade; (3) by facilitating risk management; (4) by mobilizing resources globally and thereby improving the effectiveness with which local challenges are met; (5) by obtaining information for the evaluation of business and individuals and allocating capital; and (6) by increasing the set of opportunities available to companies, entrepreneurs, and individuals to participate in and contribute to global economic growth.

This report provides narratives of companies that raised their financing in global capital markets, and also discusses *financial system architecture*—the configuration of banks and markets in a given economy. It then discusses trade credit, a significant aspect of global trade. Project financing, typically used for large investments (often involving some form of private-public partnership) is also examined in this section.

Global financial institutions, the central banks that regulate them, the interconnections between these central banks, and the regulations that affect these banks all play a role in how companies access the global markets. This discussion highlights how highly interconnected different countries are, simply through the global financial institutions that operate in these countries. An event in one country may at first seem quite remote to those living in another country—such as the crash of the Japanese stock market may seem to Americans—but if it affects the banks in the affected country, then it can affect the lending behavior of those banks in other countries, thereby transmitting economic shocks across the globe through such interconnectedness.

Apart from interconnectedness, banks are also profoundly affected by the regulations to which they are subject, and bank regulation is increasingly being internationally harmonized, especially across Europe, Canada, and the United States. The report highlights key aspects of international regulation, with a focus on the microprudential regulation of banks. These regulations affect economic growth as well as the likelihood of economic upheavals through financial crises.

Market-based financing plays a large role in the global markets. The subprime crisis of 2007–09 originated in the United States in the housing finances system. The crisis turned the spotlight on shadow banking, not just in the United States, but globally. The business community and regulators have learned from the experience of the crisis, so behavior going forward will differ significantly from the set of events that precipitated the crisis. While the term *shadow banking* conjures images of shadows and mysteries—in part because the term has become a part of our lexicon only in the past few years—it simply refers to a host of nondepository financial institutions that connect savers and investors in the financial market. Former Chairman of the Federal Reserve System Ben

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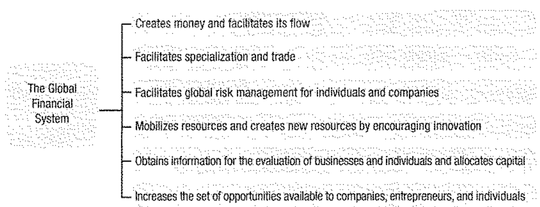
Bernanke defined shadow banks as "financial entities other than regulated depository institutions (commercial banks, thrifts, and credit unions) that serve as intermediaries to channel savings into investment."[6] Such channeling occurs through securitization and secured funding techniques.[7] The market-based financing sector is important not only because it provides significant economic services to the global economy by aiding capital formation for businesses, but also because it is large (and growing) and magnifies the interconnectedness of different countries' economies. As of year-end 2011, the size of the global shadow banking sector was estimated at $67 trillion. Moreover, because market-based financing involves investing in and borrowing against asset-backed securities, it creates interconnectedness between institutions and investors in one country and the assets that spawned the asset-backed securities in another country. For example, mortgage-backed securities created in the United States were held by banks all over the world prior to the subprime crisis, creating a scenario in which price movements in the U.S. housing market would potentially reverberate through many other countries. The market-based financing system is well understood as a vehicle for economic growth. In fact, in the November 2014 communique, G-20 leaders resolved to work in partnership to uplift growth, boost economic resilience, and strengthen global institutions—recognizing that well functioning markets support prosperity.

6. See Adrain and Ashcraft (2012).
7. See Bernanke (2010) and Greenbaum, Thakor, and Boot (forthcoming).

GLOBAL FINANCIAL MARKETS PROMOTE ECONOMIC GROWTH

The global financial system and the flows it facilitates affect global economic growth providing immeasurable benefits to individuals, companies, and societies. *Figure 3* shows the specific benefits.[8]

Figure 3. How the Global Financial System Promotes Economic Growth



Creates Money and Facilitates Its Flows

We normally think of money as being currency issued by the government. That kind of money, however, is only a component of what effectively functions as money in the economy. Four core institutions are actually engaged in the issuance of money and money-like claims in the modern financial system: the central bank, depository banks, dealer banks, and money market funds. Each type of institution issues a different kind of money-like claim, distinguished mainly by the assets backing these claims.[9]

8. This discussion is an expanded version of the discussion in Thakor (2011), which examined the interconnectedness of the domestic financial system.
9. This discussion is based on Pozsar (2014).

Figure 4 below shows the hierarchy of money claims in the economy.

Figure 4. Hierarchy of Money Claims

	Money or Money-Like Claim Issued	Assets Backing Claim
Central Bank	Currency and reserves (liabilities of central bank)	Treasury bills (federal government debt), agency debt, and residential mortgage-backed securities (RMBS)
Depository Banks Issuing Insured Deposits	Insured deposits (liabilities of commercial banks)	Loans and deposit insurance
Dealer Banks	Repurchase agreement or repos (liabilities issued by dealers' credit trading desks)	Collateralized by corporate bonds, asset-backed securities, and private-label RMBS
Money Market Funds	Constant net asset value (NAV) shares	Commercial paper, Treasury bills, and other short-term assets
Depository Banks Issuing Uninsured Deposits	Uninsured deposits	Loans and securities

All of the money-like claims shown in *Figure 4* have one thing in common—they all promise to trade at par on demand. This is why they are called *money*. That is, one can effectively use them *like* currency in transactions, even though they are not all currency. Think of writing a check against your (insured) deposit balance in the bank. That check is being used by you as currency when you pay for something using that check.

Although these are all money claims, they are not equal in terms of how they are perceived and used. One aspect in which these claims differ is in the strength of the promise to pay at par on demand and par at maturity in all states of the world.

Currency and central bank reserves are at the top of the hierarchy as the safest claim because the assets backing them—Treasury obligations in the form of bills and bonds—are the safest. Next in the hierarchy are insured bank deposits. These are almost as safe because they are insured by a government agency, the Federal Deposit Insurance Corporation, which is in turn backed by the U.S. government. Next in the hierarchy are repos, or repurchase agreements, which are secured claims and are a major form of money in the market-based financing that occurs in the shadow banking system. A repo is a contract whereby an institution borrows—typically on an overnight basis, although longer-maturity repos also exist—from another institution using eligible securities (e.g., mortgage-backed securities) as collateral. The term *repurchase agreement* is used because the contract involves "selling" the securities represented by the underlying collateral to the lender in order to raise the needed financing, and then literally repurchasing the security back, which is economically equivalent to borrowing using the securities as collateral and then repaying the loan to get the collateral back. Fourth in the hierarchy are money funds. These nondepository, market-based financing vehicles are backed by two types of assets: secured debt claims (such as repos) and unsecured debt claims. At the bottom of the money hierarchy are uninsured bank deposits, that is, deposits larger than $250,000, which is the cap on the level of deposit insurance in the United States. These are essentially unsecured claims backed by (risky) bank loans.

MONEY IS MORE THAN JUST THE FIAT CURRENCY IN CIRCULATION.

The main point of this discussion is simple. Money is more than just the fiat currency in circulation. A host of institutions participate in the process of creating money and money-like claims, and these different types of monies are used for different (sometimes overlapping) purposes, that is, for different settlement purposes. For example, the net payments of dealers and money funds are settled using demand deposits, whereas net deposit flows between banks are settled through transfers of reserves between the reserve accounts of banks that are maintained at the central bank.

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A second noteworthy point is that the creation of these different kinds of money claims facilitates transactions of various types in the economy, thereby fostering economic growth. Thus, we need the large variety of institutions described in *Figure 4* in order to ensure the creation and smooth flow of money in the financial system. Moreover, these various institutions are all interconnected in many ways, which means that we not only need variety in financial institutions, but we also need to be cognizant of how these institutions are related to each other.

A final point is that the more advanced an economy is in terms of its development, typically the greater the variety of money-like claims used for various transactions, and hence the greater the variety of financial institutions involved in the creation of these claims.

THE FINANCIAL SYSTEM ALSO FACILITATES GLOBAL TRADE BY WAY OF ALLOCATING LIQUIDITY FROM LIQUIDITY-SURPLUS AREAS OF THE WORLD TO LIQUIDITY-STARVED AREAS.

Facilitates Specialization and Trade

As indicated earlier, global trade flows are both large and growing. The financial system facilitates global trade in various ways, such as by providing the different kinds of money discussed above. Each plays a role in the global trade ecosystem. There are also offshore money market instruments like Eurodollars, which are a form of private money, like uninsured deposits. The financial system also facilitates global trade by way of allocating liquidity (money-like claims) from liquidity-surplus areas of the world to liquidity-starved areas. For example, China's high savings rate led to the accumulation of large liquidity stockpiles left over after the country's investment needs were met during the past decade. This liquidity was used by the Chinese government to buy U.S. government debt instruments, namely Treasury bonds. This, in turn, financed the debt of the U.S. government, which was used to meet the investment needs within the United States.

Specialization of tasks and functions across countries leads to differing demands for liquidity in different countries, as the global demand will also be different across tasks and functions. This means that the global financial system's ability to transfer liquidity from countries where the tasks and functions chosen for specialization exhibit a relatively low need for investment funds to countries that exhibit a higher need for investment funds is important for both the continued support of specialization and the encouragement of global trade.

Facilitates Global Risk Management for Individuals and Companies

Risk impedes investment by both individuals and companies. If a farmer is deciding how much seed and fertilizer to buy, he will worry about the vagaries of weather (rainfall, temperature, etc.) and future crop prices. In the absence of any sort of insurance against these future uncertainties, the farmer is likely to buy less seed and fertilizer and therefore harvest a smaller crop than he would if these uncertainties did not exist. This is because the farmer is naturally risk averse. In many countries (e.g., India), many (especially small) farmers operate without crop insurance, which often leads to personal ruin. This risk of ruin discourages farmers from investing as much as they could in farming. Similarly, companies are also deterred by risk, some of which may be related to regulation. One CEO of a capital-intensive firm mentioned that his company would cut back on investments in big projects due to uncertainty about future taxes because a project that looks good under current tax rates may look bad under higher future tax rates. Similarly, a local U.S. business may be deterred from entering a foreign market because all revenues would be in a local currency that has very high volatility with respect to its euro or dollar exchange rate.

> THE DEEPER AND MORE LIQUID THE GLOBAL FINANCIAL MARKET IS, THE BETTER THE RISK MANAGEMENT OPPORTUNITIES FOR INDIVIDUALS AND COMPANIES.

One of the services provided by the global financial system is *risk management*. The farmer can purchase crop insurance or use commodity futures contracts to hedge the risk of uncertain future crop prices. Similarly, a global firm that is concerned about currency risk can use currency options and swaps to hedge some of that risk. The deeper and more liquid the global financial market is for these kinds of contracts, the better the risk management opportunities for individuals and companies, and hence the higher the level of productive investment, with positive implications for economic growth.

As the global financial system evolves, it develops a greater variety of risk management instruments and processes. This enables individuals and firms to hedge against a growing variety of risks, benefiting not only them but also society because it enables them to invest more in economic growth. Consider U.S. farmers. Prior to crop insurance, the decline in net worth they suffered because of, for example, bad weather and hence a bad crop resulted in lower crop investments and lower future crop harvests. Crop insurance enables them to ride out these shocks and supply more food. Similarly, securitization of home mortgages enabled banks to better manage their risks and resulted in cheaper credit available to individuals to buy homes. And the advent of credit card securitization led to an explosion in the availability of unsecured, short-term credit to individuals. More recently, the securitization of solar panel installations in homes may usher in an era of greater solar energy use, as securitization enables risks to be taken from solar panel companies and individuals and be priced and borne in the capital market.

Mobilizes Resources and Creates New Resources by Encouraging Innovation

The above discussion makes it clear that the global financial system, through the creation of money and money-like claims and the institutions that help to create and manage the flows of these claims, makes ever-growing global trade possible. This trade mobilizes resources in the sense that the specialized resources in one location or country can be deployed to produce a product or service for another location, even when little or no demand for that product or service exists in the country in which the resource is located.

This global mobilization of resources that the financial system facilitates manifests itself in cross-border commerce and exchanges that display connectedness across a large number of countries and cities. In a 2014 report, McKinsey examined 131 countries and ranked each country based on its connectedness in each type of flow (goods, services, finance, etc.).[10] According to this analysis, Germany is the most connected country in the world; that is, it helps in the global mobilization of resources more than any other country. The second-, third-, and fourth-ranked countries are Hong Kong, the United States, and Singapore, respectively. Developed countries are much more connected than developing countries. This means that there is substantial scope for growth in the connectedness of countries in the future, and therefore for enhanced global mobilization of resources.

Participating in the global mobilization of resources is enormously beneficial to a country; hence, a global financial system that fosters this mobilization also boosts the economic growth of nations. Singapore is a good example of this. Although its population

10. See McKinsey Global Institute (2014).

in 2012 was only 5.3 million people, Singapore had a GDP of $275 billion, making it the 35th largest economy in the world—quite a feat for a country that small. It has achieved this success mainly by being a strong intermediary of flows moving between other countries, especially in goods and financial flows. It represents a major financial center in Asia, and it has made significant investments in infrastructure and education.

While the impact of the global financial system on the mobilization of resources and the growth of global trade is easy to see, what is perhaps less transparent is the impact that resource mobilization has on innovation. Two of the biggest impediments to innovation are lack of funding and lack of talent or people. A strong global financial system helps to reduce these impediments. By making it easier for individuals and institutions to invest anywhere in the world, innovation can be funded even in areas of the world where there is a dire paucity of local resources. Moreover, as financial capital flows in to support innovation in a given region, it becomes easier to attract human capital to follow. Singapore again provides a good illustration of this idea. The country has developed a highly trained workforce and high-tech manufacturing facilities to transform lower-valued imports into higher-valued exports, and has in recent years has focused increasingly on developing a stronger research and development ecosystem by allocating more funding to universities to attract internationally renowned, research-oriented faculty to help create research departments, laboratories, and so on. As a result, its value-added contribution in knowledge-intensive industries such as electronics, biotechnology, and pharmaceuticals is growing.

TWO OF THE BIGGEST IMPEDIMENTS TO INNOVATION ARE LACK OF FUNDING AND LACK OF TALENT OR PEOPLE. A STRONG GLOBAL FINANCIAL SYSTEM HELPS TO REDUCE THESE IMPEDIMENTS.

Obtains Information for the Evaluation of Businesses and Individuals and Allocates Capital

One impediment to the exchange of capital between savers and entrepreneurs and investors is that savers may have difficulty assessing whether a particular investment is worthwhile. If a private business comes to an individual and asks for money to grow, the individual is likely to say no for two reasons: asymmetric information and moral hazard. The asymmetric information problem is that the private business owner knows more about his own business than the individual saver does, and therefore has an incentive to misrepresent this information to obtain funding at favorable terms. For example, the business may overstate its growth potential and understate its true costs, thereby presenting an inflated picture of future profits. The moral hazard problem is that once the money is obtained, the business may not put it to the best use. For example, the manager in charge may waste money on a large office for himself, with plush carpets and expensive paintings. Or he may not work as hard as the shareholders would like, thereby putting his own desire for leisure above the interests of the shareholders. These two frictions—asymmetric information and moral hazard—may cause an individual saver to avoid investing in a private business that he does not know enough about.

INVESTMENT FROM THE PRIVATE EQUITY FIRM ALLOWS THE BUSINESS TO OBTAIN FUNDING AND GROW. PRIVATE EQUITY FIRMS ROUTINELY INVEST IN HUNDREDS OF COMPANIES, PROVIDING BOTH MANAGERIAL EXPERTISE AND MUCH NEEDED GROWTH CAPITAL.

Enter a private equity firm like Bain Capital. Its experts can conduct the appropriate due diligence to resolve the asymmetric information problem. Additionally, it can appoint its own employees to the business's management positions to resolve the moral hazard problem. Investment from the private equity firm allows the business to obtain funding and grow. Private equity firms routinely invest in hundreds of companies, providing both managerial expertise and much needed growth capital. For example, Bain Capital's decade-long investment in Domino's Pizza helped the company to expand, become more efficient, and add value to the economy. Similarly, private equity firms are buying up small health care providers, professionalizing their management, improving efficiency, and injecting more capital. In the end, if health care has a brighter future, it is likely going to be because of these sorts of market-based initiatives.

> PRIVATE EQUITY FIRMS, BANKS, VENTURE CAPITALISTS, AND A HOST OF OTHER INSTITUTIONS THAT MAKE UP THE GLOBAL FINANCIAL SYSTEM HELP MAIN STREET TO RAISE FINANCING.

Private equity firms, banks, venture capitalists, and a host of other institutions that make up the global financial system help Main Street to raise financing, fund growth, and create enhanced economic value in countless ways. A key component of their ability to accomplish these tasks is their expertise in resolving asymmetric information and moral hazard problems that impede the flow of capital from savers to businesses.

Increases the Set of Opportunities Available to Companies, Entrepreneurs, and Individuals

The growth of the global financial system creates new opportunities for businesses and governments to drive economic growth, and it increases access for new participants, in addition to expanding opportunities for innovation. Of course, the benefits of the financial system can be experienced by a country only if it is open to international financial flows, and the more open the country, the greater the benefit.

What is the source of the benefit? Research has shown that greater financial openness leads to a higher total factor productivity (TFP), where TFP is defined as a variable that determines how effectively an economy transforms productive inputs into output (GDP). Research has uncovered strong causal evidence that foreign direct investment and portfolio equity liabilities boost TFP growth.[11] Thus, one important effect of a deeper and broader global financial market is that it provides inducements for countries to open their economies to global flows as it becomes easier for the companies in these countries to tap the market for capital. As the benefits of participating in the global financial system increase, the implicit penalty for being left behind also increases. Companies in more and more countries will adapt their business models to an increasingly connected, competitive, and digitized world.

> VAST OPPORTUNITIES FOR INDIVIDUALS AND BUSINESSES ARE BEING CREATED BY THE GROWING GLOBAL FINANCIAL SYSTEM AND GLOBAL TRADE.

Vast opportunities for individuals and businesses are being created by the growing global financial system and global trade. McKinsey reports that for the 100 largest companies in the world that are headquartered in developed countries, only 17% of global revenue in 2010 was derived from emerging markets, even though emerging markets represented 36% of global GDP.[12] This means that there is still untapped growth potential and unharvested opportunities. This is further underscored by the fact that by 2025, emerging economies will contribute 70% to

11. See Kose, Prasad, and Terrones (2008).
12. See McKinsey Global Institute (2014).

global GDP. Moreover, while in the past investment capital came mostly from the developed countries, in the future it will come from the developing countries. To support this claim, note that in 2000, developing countries had aggregate investments that represented 4.5% of global output, whereas savings were at about 4%. The gap between these two was the external finance that these countries needed for investment. Since 2000, however, developing countries have been saving more than they have been investing, generating an investible surplus of more than $340 billion per year.[13] This means that this growing pool of capital in the developing economies will continue to fund an increasing array of opportunities in the developed world.

13. See Kharas (2014).

HOW THE GLOBAL FINANCIAL SYSTEM MEETS THE NEEDS OF MAIN STREET

This section provides specific examples of companies that raised capital in the global financial market and how this capital fueled their growth. Such growth, in turn, increases employment and leads to a more prosperous society. The section then discusses the broader issue of financial system architecture and its link to economic growth.[14] A discussion of trade credit, which is a key component of international trade and an important way in which the global financial system helps to meet the needs of Main Street, follows. The section ends with a discussion of project finance.

Novo Industri A/S

Novo Industri A/S (Novo) is a Danish multinational firm that produces industrial enzymes and pharmaceuticals.[15] Prior to 1977, Novo was largely confined to Denmark, raising funds only locally. But its management realized that the Danish capital market was segmented from other capital markets—it displayed little interconnectedness—and lacked sufficient liquidity. This meant that Novo not only faced a high cost of capital, especially equity capital, but also did not have access to a plentiful supply of capital. These restrictions put it at a competitive disadvantage with respect to the multinational pharmaceutical firms it competed with, such as Eli Lilly from the United States and Gist Brocades from the Netherlands.

14. The term "financial system architecture" coined by Boot and Thakor (1997a), refers to the mix of financial institutions and markets in an economy.
15. This discussion is based on Moffett, Stonehill, and Eiteman (2009).

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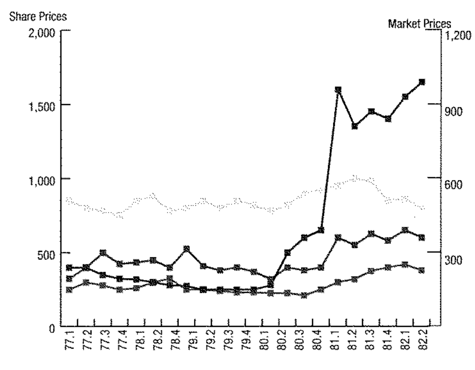
Many features of the Danish equity market led to a relatively high cost of capital for firms seeking financing. One feature was asymmetric information. Denmark had a regulation that prohibited Danish investors from holding foreign private-sector securities, which gave little incentive for Danish investors to work to acquire information or to follow markets outside Denmark. Another problem that worsened the asymmetric information friction was the paucity of equity analysts. Taxation policy in Denmark did not help either. Investors were charged a capital gains tax of 50% on shares held for over two years, and gains on those held for a shorter period were taxed at a staggering 75% (the marginal income tax rate).

Novo saw significant growth opportunities on its horizon, for which it needed investment capital. It decided that it could no longer confine itself to the illiquid Danish capital market where equity capital was so expensive. So in 1977, Novo decided to access the global financial market. A big barrier the company had to overcome was asymmetric information. So it began disclosing its financials in accordance with international standards. In 1979, the company sold a $20 million convertible Eurobond issue and listed its shares on the London stock exchange. This action encouraged equity analysts in London to follow the company and this reduced asymmetric information. That year also saw a big biotechnology boom in the United States and Novo decided to visit the United States to explore the market. Novo conducted a successful road show and U.S. investors began to purchase its shares on the London stock exchange. In 1981, Novo listed on the New York Stock Exchange and experienced an increase in its stock price as the proportion of share ownership of investors outside Denmark went from zero to about 30%. Novo's price-to-earnings ratio rose to 16, in line with the ratios enjoyed by its international competitors. Novo's stock price rose well above the Danish industry index, an indication that Novo had succeeded in its capital cost. *Figure 5* shows behavior of Novo's stock price.

Figure 5. Novo's B-Share Prices Compared with Stock Market Indices



Source: *Stonehill and Dullum*

An interesting aspect of this case study involves how the transition from a segmented capital market to a global capital market changes investors' reactions to capital-raising efforts. Novo's proposed share issue in the United States was greeted on the Danish stock exchange by a drop in its stock price. This is not surprising for a relatively illiquid stock market in which investors are worried about the dilution effects of the stock issue. By contrast, when trading started in New York, the stock price rose—a reaction one would expect in a liquid stock market in which investors believed that Novo would invest its capital at a rate of return exceeding its cost of capital.

A number of useful lessons emerge from this case study. First, segmented capital markets tend to be relatively illiquid and firms that are confined to raising their capital in

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such markets experience high costs of capital that can stunt their growth. When such firms decide to access the global capital market, they experience a decrease in their cost of capital, which helps their growth. Thus, global capital markets help Main Street by lowering the cost of capital for firms and helping them to grow faster. Second, global capital markets also level the playing field for firms vis-à-vis their large international competitors, by giving them access to the same low-cost sources of financing that these international competitors enjoy.

Bunge Corporation

Bunge Corporation is a global agribusiness firm. It trades in agricultural products, buys grains from farmers all over the world, and has crushing plants in which the grains are crushed to make oil, which is then sold to establishments like McDonald's. The company also makes and sells certain food products like margarine and mayonnaise.

> BUT THE COMPANY WAS STILL PRIVATE, WHICH MEANT THAT IT DID NOT HAVE ACCESS TO THE FULL RANGE OF FINANCING POSSIBILITIES THAT TAPPING THE GLOBAL CAPITAL MARKET WOULD PROVIDE.

The company was founded in Amsterdam in 1818 as an export and import trading firm. In 1859, the firm relocated to Antwerp, where it became one of the world's leading commodities traders. In 1905, the company established an office in Argentina, a booming agribusiness market, and traded grains. In 1935, Bunge built its first major grain handling facility in the United States and became an originator of grain in North America. The company entered Brazil in 1938, and became both a supplier (of fertilizers, financing, etc.) to and a customer (grains purchases) of farmers. The first soybean processing plant in the United States was built by Bunge in 1967.

The company continued to expand through the rest of the 20th century and management had even more ambitious growth plans that it wanted to pursue. But the company was still private, which meant that it did not have access to the full range of financing possibilities that tapping the global capital market would provide. Thus, in 2000, Bunge moved its global headquarters to White Plains, New York, to be closer to the heart of the global capital market, and in 2001, the company decided to go public by listing on the U.S. stock exchange.

After going public, Bunge grew rapidly. It acquired LaPlate Cereal in 2001 to become the leading agribusiness company in Argentina. In 2002, the company acquired Cereol to become the world's largest soy producer in Europe. In 2005, the company purchased its first soybean crushing and refining plant in China. This growth spurted even more in 2006 as the company opened a soybean processing plant in Spain and an oil packaging plant in Texas. It also purchased its second soybean processing plant in China. In 2007, Bunge purchased its first sugarcane mill in Brazil and acquired consumer vegetable oil brands in Romania and a food service brand in Brazil. While the financial crisis in 2008 hampered many firms, Bunge continued on its strong growth trajectory, acquiring German margarine producer Walter Rau and buying a majority stake in a second sugar and ethanol mill in Brazil. The expansion continued into 2010 as Bunge added five new sugarcane mills to its existing three in Brazil. As a result, the company now owns a large-scale sugar and bioenergy business capable of producing various sugar and ethanol products.

Bunge's growth during the past 14 years or so has coincided with its decision to go public on the New York Stock Exchange and tap the global financial market in order to support its growth strategy. This was not a coincidence. It was part of a deliberate strategy.

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When Bunge went public in 2001, its revenue was about $11.5 billion and the book value of its equity was approximately $1.38 billion. At year-end 2013, Bunge's annual revenue stood at approximately $61.35 billion and the book value of its equity was approximately $10.09 billion. This growth resulted both from the value-enhancing growth strategy adopted by Bunge's management and the lower cost of financing owing to the company's decision to access the global financial market. As a result of this growth, Bunge has created thousands of jobs throughout the world and has made significant contributions to the global agribusiness value chain, thereby helping to feed the world.

Financial System Architecture

While global financial markets help companies tap liquid pools of capital to grow, these markets are just one component of a global financial ecosystem. The global financial system includes financial institutions as well as markets. A long-standing question in economics has to do with the architecture of the financial system; that is, the relative roles played by banks and markets in the allocation of capital to individuals and firms.[16] The question is, which architecture is better for economic growth—a market-dominated architecture or a bank-dominated architecture? In a market-dominated financial architecture—such as the one in the United States—the economy relies more on the stock and bond markets than on banks to allocate capital, whereas in a bank-dominated financial architecture—such as the one in continental Europe—banks are more

THE QUESTION IS, WHICH ARCHITECTURE IS BETTER FOR ECONOMIC GROWTH—A MARKET-DOMINATED ARCHITECTURE OR A BANK-DOMINATED ARCHITECTURE?

16. One of the earliest theoretical analyses of financial system architecture appears in Boot and Thakor (1997a).

important than financial markets in allocating credit to individuals and businesses.

> IT IS BY NOW WELL ACCEPTED THAT BETTER-FUNCTIONING FINANCIAL SYSTEMS—THOSE THAT ARE MORE OPEN AND COMPETITIVE—IMPROVE RESOURCE ALLOCATION, REGARDLESS OF WHETHER THE FINANCIAL SYSTEM IS BANK-DOMINATED OR MARKET-DOMINATED.

It is by now well accepted that better-functioning financial systems—those that are more open and competitive—improve resource allocation, regardless of whether the financial system is bank-dominated or market-dominated. Moreover, it has also been found that external finance has a greater effect on different industries in more financially developed countries.[17] Research suggests that both financial intermediaries and markets affect economic growth and that reverse causality alone—meaning there is a greater demand for the financial system in more well-developed economies—is not driving this finding.[18] The mechanism driving this result appears to be that better-developed financial systems ease firms' financing constraints, making it easier and less expensive to raise capital. Thus, at one level, if we are mainly interested in how the overall financial system affects economic growth, then it matters little whether the development of the financial system comes from better-developed banks or better-developed markets.

However, specific aspects of development may be affected in different ways by whether a financial system is market-dominated or bank-dominated. For example, we may wish to know whether financial innovation is likely to be greater in a particular system, or if technological innovation is more likely in one system than the other.

17. See Levine and Zervos (1998).
18. See Levine (2005).

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A theoretical contribution showed that market-dominated financial systems—in which commercial and investment banks are functionally separated—tend to produce more financial innovation than bank-based financial systems.[19] One can see this in the financial innovations that have occurred in the United States compared with Europe. Financial institutions and other financial market participants in the United States have produced a staggering array of financial innovations that have helped individuals and institutions better manage risk, avail of lower capital costs, make investments they would otherwise not have made, and grow. Examples are options, futures and swap contracts, securitization, mutual funds, and ETFs, just to name a few. All these are attributable to the United States but are now used globally in large volumes—a testimony to the value they provide to the global economy.

THE STUDY'S MAIN FINDING IS THAT A MORE MARKET-ORIENTED FINANCIAL SYSTEM LEADS TO HIGHER TECHNOLOGICAL PROGRESS. MOREOVER, TECHNOLOGICAL PROGRESS IS ALSO POSITIVELY INFLUENCED BY A HIGHER PRESENCE OF FOREIGN BANKS, A MORE COMPETITIVE BANKING SYSTEM, A STRONGER PROPENSITY ON THE PART OF COMPANIES TO GO PUBLIC, AND LOWER STOCK MARKET VOLATILITY.

Similarly, a recent empirical study examined whether a country's type of financial system—bank-dominated or market-dominated—affects the rate of technological change in the country, with a positive impact on long-run economic growth.[20] The dependent variable in this study is technological change and the key independent variable is the country's financial architecture.[21] Other independent variables include the percentage of banking accounted by foreign banks and

19. See Boot and Thakor (1997b).
20. The discussion below is based on Giordano and Guagliano (2014).
21. Financial architecture is measured by how total stock market capitalization relative to GDP compares with bank credit relative to GDP, measures of market efficiency (total value of shares traded divided by average market capitalization), and so on.

measures of banking concentration such as the percentage of banking assets in the hands of the top three banks. The study's main finding is that a more market-oriented financial system leads to higher technological progress. Moreover, technological progress is also positively influenced by a higher presence of foreign banks, a more competitive banking system (one that exhibits lower concentration among a few large banks and has a lower lending-deposit interest rate spread), a stronger propensity on the part of companies to go public, and lower stock market volatility.

THUS, IF THE FINANCIAL SYSTEM LACKS A GOOD BANKING SYSTEM, IT IS DIFFICULT FOR THE STOCK AND BOND MARKETS TO FUNCTION EFFICIENTLY.

These findings point to the importance of not only a well-developed financial system, but also one in which capital markets (both stock and bond markets, as well as markets for options, futures, and other derivatives) flourish. This means having the appropriate amount of capital market regulation, but not so much that it inhibits growth, stifles innovation, and creates such excessive costs of regulatory compliance that companies prefer to go to other regulatory jurisdictions.[22] Another point to keep in mind is that one cannot conclude from studies like the one discussed above that capital markets should be developed at the expense of robust and well-functioning banking systems. An analysis of the Romanian financial system shows that if attention in reforming a former centrally planned economy is focused primarily on launching a stock market when the banking system is still primitive, then the economy does not reap the benefits of market development that is found in economies with strong banking systems.[23] The reason is that banks play important roles in a market's function. One of these roles is lending to informationally opaque borrowers and

22. See Thakor (2011) for a discussion of this issue.
23. See Myendorff and Thakor (2002).

allowing them the opportunity to develop as creditworthy firms before going public. Other roles are providing loan commitments to public firms, expanding their access to liquidity, and providing lines of credit to back up commercial paper issues in the capital market.[24] Thus, if the financial system lacks a good banking system, it is difficult for the stock and bond markets to function efficiently.

Trade Credit

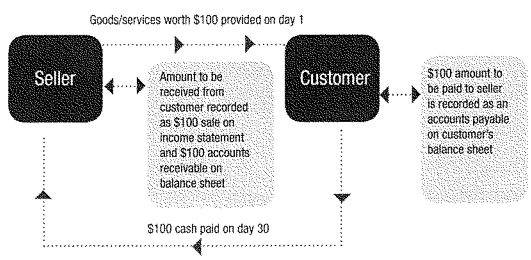
Trade credit typically involves the extension of credit by a firm to its customers. The most common form of trade credit occurs when a firm extends credit to its customers by selling goods or services and allowing the customer to pay at some date after the receipt of the goods or service. In accounting terms, the seller records the transaction as a sale and then the amount yet to be received from the customer as an accounts receivable, an asset item on the seller's balance sheet. If the customer remits payment to the seller within a contractually predetermined time (say 30 days), then the credit does not receive a financing charge. However, if the customer takes longer to pay, a financing charge is assessed. So, in effect, the firm acts as a short-term financier to its customers. Similarly, when the firm receives input from its suppliers to make the product or service it sells, it promises to pay its suppliers within a predetermined time after receiving the goods or service. Thus, the firm's suppliers effectively become its short-term financiers.

Dell Computers created a whole business model based on this premise. When you place an order for a Dell computer online and provide your credit card information, the company gets paid within 24 hours. In most cases, the laptop that is ordered is essentially put together by the components provided by Dell's suppliers, who get paid by Dell 30 days

24. See Boot, Greenbaum, and Thakor (1993) and Shockley and Thakor (1997) for analyses of loan commitments and how they help firms to finance and grow.

later. Thus, Dell's suppliers become its de facto short-term financiers and Dell will record the payment it owes its suppliers as an accounts payable on its balance sheet. *Figure 6* shows how trade credit works.

Figure 6. Trade Credit



As the above discussion explains, trade credit is a partial substitute for a bank loan. If the seller were not to give the customer time to pay for the purchased goods or service, the customer would have to borrow that amount from a bank. What then is the relationship between the characteristics of a country's banking system and the extent of trade credit? Considerable research has been done on this issue. Using firm-level data for 39 countries, a study computed payables and receivables turnovers and examined how they differed across financial systems.[25] The study documented that the development of a country's banking system and legal infrastructure predicts the use of trade credit. Firms' use of bank debt relative to trade credit is higher in countries with more efficient legal systems. The reason is that when the legal system is less efficient, the rights of creditors are less protected and less strong, which then induces banks to possibly curtail the supply of credit

25. See Demirgüc-Kunt and Maksimovic (2001).

or charge more for it. Because a seller has ways outside the formal credit-rights-protection regime with which to "punish" the borrower for not paying—by refusing to sell products or services in the future, for example—trade credit is less sensitive to the strength of creditor rights than is bank credit. Therefore, in countries in which the legal system is less efficient, trade credit substitutes for bank loans to a greater extent and is more important.

The study also finds that firms in countries with larger and privately owned banking systems offer more financing (trade credit) to their customers, and also take more financing (higher payables) from them. That is, the aggregate amount of trade credit relative to bank loans is higher in these countries. Therefore the provision of trade credit complements the role played by banks and other financial intermediaries.

The importance of trade credit in promoting higher global trade flows cannot be overstated. A recent study examined how important trade credit is for global trade.[26] At first glance, it becomes apparent that these are large flows. Using a database that covers almost 100 countries and the 2005–11 time period, the study notes that the total amount of trade credit recorded annually is close to $1 trillion, and annual global trade flows during this period are about $18 trillion. The study notes that, in practice, it is difficult to establish a causal effect of trade credit on trade because of *reverse causality* concerns—the volume of trade demand affects the demand for trade credit, and trade credit availability affects trade. To overcome this problem, the study uses a careful two-stage econometric approach. In the first stage, the study finds that the volume of available insured trade credit is strongly correlated with economic and financial conditions over a full economic cycle. Trade credit is significantly determined by the level of liquidity in the economy and by GDP as a measure of national income. Then in the second stage, the study finds that trade credit is a strong determinant of trade.

Thus, three broad conclusions emerge. First, when we think about the global

26. The following discussion is based on Auboin and Engemann (2013).

financial system as consisting of a variety of financial institutions, financial instruments, and markets, we should also consider trade credit as an important component of the system. In fact, although trade credit is a partial substitute for bank credit, it is positively affected by the development of the global financial system. The ability of the seller to avail of low-cost financing options in the interconnected global financial system enables the seller to offer trade credit at favorable terms to its customers. Second, the availability of trade credit has a positive effect on global trade. In other words, trade credit is good for Main Street—it facilitates imports of goods and services which benefits all market participants. Finally, trade credit represents another way in which the global financial system becomes more interconnected, in the sense that it links firms and their customers—and hence their banks as well, since these banks provide letters of credit and stand-by letters of credit to facilitate trade—across national boundaries.[27]

TRADE CREDIT IS GOOD FOR MAIN STREET—IT FACILITATES IMPORTS OF GOODS AND SERVICES WHICH BENEFITS ALL MARKET PARTICIPANTS.

Project Finance

Project financing is a technique for financing large-scale infrastructure projects, including those in natural-resource sectors of the economy, such as energy and mining.[28] It has become quite popular as a way for financing projects (sometimes with government assistance) that may otherwise be considered too large or risky for companies to invest in. The typical approach in project financing is to incorporate the project separately as an

27. See Greenbaum, Thakor, and Boot (forthcoming) for a discussion of letters of credit and stand-by letters of credit.
28. This discussion is based in part on Greenbaum, Thakor, and Boot (forthcoming).

independent entity so that those who provide financing get a claim only on the cash flows of the project. The firm that sponsors the project invests some equity, and may involve as equity sponsors others like investment banks. In addition to the equity provided by the project sponsors, a substantial fraction of the financing is provided by debt that is typically *nonrecourse* to the sponsors. Nonrecourse debt means that the lenders have a claim only against the cash flows of the project and not against any other cash flows of the sponsor.

Project financing is used for many reasons. First, because the cash flows of the project are not commingled with those of the sponsor, asymmetric information is less of a problem for the lender than would otherwise be the case. This lowers the lender's information processing costs and results in a lower cost of capital for the sponsors. Second, the absence of cash flow commingling also means that moral hazard—the propensity of the sponsoring firms to increase the risk to which project lenders are exposed by activities in other parts of the business that are difficult for the lenders to monitor—is minimized. This has two effects: it reduces the cost of capital for the project and also allows a higher amount of debt to be used, which generates bigger tax savings. Finally, because the debt is nonrecourse to the sponsors, the project leaders have to claim against the other assets of the sponsors, so sponsors do not expose themselves to the risk of financial distress in the event the project experiences difficulties. This is especially important for large projects.

Project financing was used during the 1970s in the development of North Sea oilfields and also in the U.S. power market in the late 1970s and 1980s.[29] Perhaps the most prolific use of project financing has been in the United Kingdom, where something called the "Private Finance Initiative" (PFI) has been used. PFI was started in 1992 and has been managed by the British government as a systematic public-private partnership program. The way it works is as follows. The government forms a partnership with a private sponsor

29. The discussion here is based in part on Gardner and Wright (2014).

to build some infrastructure—street lighting, schools, roads, and so on. In exchange, the sponsor receives a long-term *concession*, which is essentially a defined revenue stream over the life of the contract that provides returns to the sponsors' investors. This arrangement has many benefits for project sponsors as well as taxpayers, which is why project financing has grown. *Figures 7a* and *7b* provide data on project financing transactions by region and by country, and *Figure 9* provides data by sector. It is apparent that power and transportation projects dominate the project financing market.

Figure 7A. Project Finance Transactions by Region

	2010		2007	
	US$m	%	US$m	%
Asia Pacific	98,708.30	47.42%	44,842.30	20.38%
EMEA	83,931.20	40.32%	130,667.30	59.40%
Americas	25,534.50	12.27%	44,476.30	20.22%
Global Total	**208,173.90**	**100.00%**	**219,985.90**	**100.00%**

Source: *Thomson Reuters Project Finance International.*

Figure 7B. Project Finance Transactions by Country (2010)

Country	US$m	%
India	54,801.70	26.32%
Spain	17,376.10	8.35%
Australia	14,592.10	7.01%
United States	13,423.80	6.45%
United Kingdom	13,020.80	6.25%
Taiwan	12,064.40	5.80%
Saudi Arabia	10,000.20	4.80%
Switzerland	5,371.20	2.58%
France	5,350.70	2.57%
Italy	5,014.50	2.41%
Top 10 Total	**151,015.50**	**72.54%**
Global Total	**208,173.90**	**100.00%**

Source: *Thomson Reuters Project Finance International; and Gardner and Wright (2014).*

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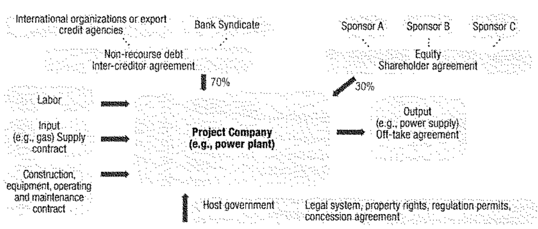
Figure 8. Project Finance Transactions by Sector (2010)

Sector	US$m	%
Power	73,300.40	35.21%
Transportation	52,315.40	25.13%
Oil & Gas	25,950.80	12.47%
Leisure & Property	13,824.20	6.64%
Telecommunications	13,382.70	6.43%
Petrochemicals	11,306.40	5.43%
Mining	8,857.70	4.25%
Industry	6,306.00	3.03%
Water & Sewerage	1,577.50	0.76%
Waste & Recycling	1,266.60	0.61%
Agriculture & Forestry	86.30	0.04%
Global Total	**208,173.90**	**100.00%**

Source: *Thomson Reuters Project Finance International.*

A typical project financing structure involves multiple contracting relationships as shown in *Figure 9.* Hybrid structures that combine features of conventional financing and project financing are also being developed. With these structures, the debt financing provided to the project is still nonrecourse to the sponsor, but lenders diversify some risk away by financing portfolios of projects rather than single projects. Moreover, in some project financing ventures with private-public partnerships, private financiers assume construction and operating risks and host governments take on market risks.

Figure 10. Typical Project Finance Structure



THE GLOBAL FINANCIAL LANDSCAPE: REGULATION OF MARKETS AND BANKS AND THEIR INTERCONNECTEDNESS

The global financial system has many regulators who watch over and formulate rules of conduct for the players who transact with each other in that system. An important goal of these regulators is to enhance financial stability. The nature of regulation depends in part on the architecture of the financial system discussed earlier. This section briefly discusses how financial markets and banks are regulated, and how the desire for global financial stability creates interconnectedness in the actions of regulators.

Financial Markets: The Regulators

The regulatory bodies involved in global financial markets are far too numerous to enumerate here, so the focus will be rather selective. Specifically, this report will discuss broadly the role of regulators in financial markets and the major goals of regulation, especially on an increasingly interconnected financial system. In the context of this discussion, some of the major regulators and the roles that they play will be discussed.

Consider first *financial market regulation*. For simplicity, this section focuses on the stock market, but it is easy to extrapolate the main ideas to other financial markets as well. The Securities and Exchange Commission (SEC) states its mission on its website as "to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." When one thinks about this mission carefully, one sees a tension in the

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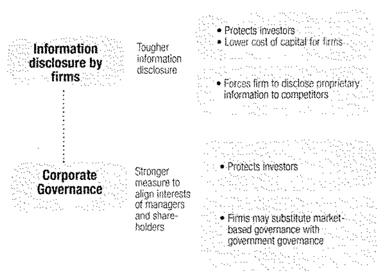
regulatory goals of the SEC, which regulates U.S. capital markets. On the one hand, the SEC seeks to protect investors. This means the SEC must insist on a stringent set of information disclosure requirements to ensure that investors do not end up buying lemons when they purchase stocks traded on U.S. exchanges. This assurance creates confidence in the stock market and encourages broader investor participation in the market. Whenever firms from other countries come to list on U.S. exchanges, they find that the information disclosure requirements far exceed what they have been accustomed to. The requirements create greater transparency and a more liquid capital market in which there is greater investor participation. But on the other hand, firms are also reluctant to disclose too much information because any information that they disclose to investors is also (inadvertently) disclosed to their product-market competitors.[30] Thus, if information disclosure requirements become too stringent, firms may be chased away to other regulatory jurisdictions, which would interfere with the SEC's second goal, namely facilitating capital formation. Thus, an appropriate balance must be maintained.

Another aspect of investor protection that is implicit to the SEC's mission is ensuring effective *corporate governance* so that the well-known divergence of interests between managers and investors does not significantly hurt investors' interests.[31] This means companies must have independent directors on corporate boards who look out for the interests of investors, besides providing counsel to the firm's managers. But here too a tension exists. The SEC seeks to use its own reporting requirements and other guidelines to add to the quality of the governance the firm would have in the absence of these SEC mandates. And yet, the possibility exists that the more effective the SEC becomes in

30. Bhattacharya and Ritter (1983) were the first to observe this spillover effect in their theory of optimal information disclosure. Thakor (2014) shows how greater information disclosure about strategy can create a risk of funding denial for the firm.
31. Jensen and Meckling (1976) introduced this divergence to finance and studied its implications for ownership and capital structure.

ensuring this, the more it substitutes the governance that would be provided anyway; that is, the improvement in governance provided by the SEC crowds out governance that the firm would have had anyway. A recent study documents empirically that this is what happened when the SEC was created.[32] Thus, governance reform must always must be cognizant of this *substitution effect*, whereby government-sponsored (SEC) governance effectively ends up substituting for market-based governance. A key implication is that the SEC's governance efforts should be focused in areas in which market-based governance is weak or fails altogether. *Figure 10* depicts these tensions in the regulation of securities markets.

Figure 11. Tensions in the Regulation of Securities Markets



Bank Regulators

Let us now turn to bank regulation. Banks are institutions that are typically regulated by the central banks in the countries in which they are headquartered and operate. In the United States, the Federal Reserve System (Fed) regulates banks; in Europe, the European Central Bank (in addition to national regulators) fills this role. The U.S.

32. See Avedian, Cronqvist, and Weidenmier (2014).

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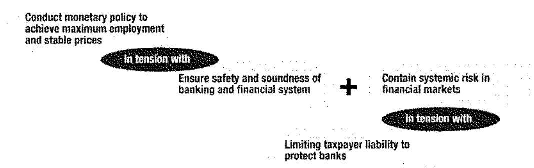
Federal Reserve System states its duties as falling into four categories:

- Conducting the nation's monetary policy by influencing the monetary and credit conditions in the economy in pursuit of maximum employment, stable prices, and moderate long-term interest rates;
- Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights on consumers;
- Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets; and
- Providing financial services to depository institutions, the U.S. government, and foreign official institutions, including playing a major role in operating the nation's payments system.

The Fed has to cope with various tensions in the conduct of its policies. For example, increasing employment might call for the Fed to encourage banks to lend more, which may call for a loose monetary policy and low interest rates. However, to expand lending, banks may have to make riskier loans, which can jeopardize the Fed's goal of containing systemic risk. This tension may also play out in the Fed pursuing its goals of microprudential regulation by increasing capital requirements for banks, but bankers may claim that this will reduce lending and limit economic growth. Similar tensions may exist when it comes to protecting the credit rights of consumers. On the one hand, the more extensive the set of consumer protection laws and the more vigorous the enforcement of these laws, the potentially greater the protection offered to consumers. But on the other hand, the costs imposed on banks for developing compliance procedures and filling out the necessary paperwork to document compliance are higher. As a central bank, the Fed always walks a fine line in navigating these competing priorities. Yet another tension exists between the desire to prevent bank failures (the stability objective) and the desire to limit the exposure of taxpayers who must provide assistance to prevent banks from failing. These tensions are depicted in *Figure 11*.

Figure 11. Tensions in the Regulation of Banks



The mandate of the European Central Bank (ECB), the bank regulatory agency for the European Union, is similar to that of the Fed, but it is not the same. The ECB states its primary objective as follows:

> "The primary objective of the European System of Central Banks ... shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the objectives of the Union as laid down in Article 3 of the Treaty of the European Union."

The ECB defines its basic tasks as follows:

- The definition and implementation of monetary policy for the euro area;
- The conduct of foreign exchange operations;
- The holding and managing of the official foreign exchange reserves of the euro area countries (portfolio management); and
- The promotion of the smooth operation of payments systems.

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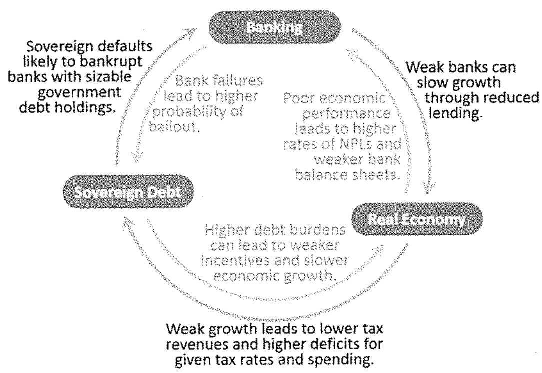
The differences between the Fed's mandate and the ECB's mandate are related in part to the fact that each country within the European Union also has its own central bank with supervisory and regulatory domain over the banks in the country.

The tensions and related challenges faced by central banks typically come to a head during financial crises. It is important to note that every financial crisis is preceded by some problems in the "real" (nonfinancial) sector of the economy and the crisis, in turn, also affects the real sector. That is, a financial crisis is typically generated by some problems in the real sector, but the crisis then has its own independent adverse effect on the real sector, making the initial problem worse and more persistent. Consider the manner in which the 2007–09 financial crisis played out in the euro area. It has been proposed that three interlocking crises occurred, as shown in *Figure 12*.[33] The first was an *economic recession*, which has been referred to as a "growth crisis."[34] The second was a *banking crisis*, and the third was a *sovereign debt crisis*. Poor economic conditions such as a recession, cause borrowers to become delinquent on their bank loans, which then increases nonperforming loans on banks' balance sheets, causing bank equity to decline, leading to a reduction in bank lending.[35] In extreme cases, loan defaults can be so high that banks may fail. This may lead to bailouts by the respective sovereign governments,[36] which may put significant financial stress on the public finances of these countries, especially since these events are likely to coincide with lower tax revenues (because there is an economic recession). This can eventually lead to a sovereign debt crisis if this financial stress threatens the ability of the government to make payments on its debt obligations.

33. See Noeth and Sengupta (2012) and Shambaugh (2012).
34. See Shambaugh (2012).
35. This chain of events is referred to as the "bank balance sheet channel." See Bernanke and Gertler (1995).
36. Bailouts may occur through the government either paying off depositors under its deposit insurance scheme or recapitalizing banks or both.

Figure 12. Three Interlocking Crises in the Euro Area



Note: *NPLs are nonperforming loans.*

Source: *Shambaugh (2012).*

Regulatory Actions to Achieve Financial Stability Create Greater Interconnectedness

Event chains like the one described above often cause central banks to intervene massively in financial markets. And because economic conditions have common elements across countries, the actions of major central banks also end up being connected. Consider what has happened since the bursting of the real estate bubble in 2007 that led to the 2007–09 crisis. The major central banks of the most developed countries (ECB, the Bank of England, the U.S. Federal Reserve, the National Bank of Switzerland, and the Bank of Japan) have all loaned massive amounts of money to their banks to ensure that they do not fail. The aggregate amount of lending from central banks to the private financial sector since 2007 is estimated to exceed $20 trillion.[37]

Some of this lending has been indirectly linked to the market-based financing since it was provided to banks that were, in turn, using their resources to bail out or financially support their own *money market funds* (MMFs). An MMF is a mutual fund that collects money from individuals and, in exchange, gives them equity claim on the fund. MMFs invest the money in short-term debt securities like U.S. Treasury bills and commercial paper. MMFs are often regarded as a close substitute for bank deposits because they are liquid and have relatively low risk but provide higher yields than deposits. However, during the financial crisis, it was discovered that MMFs were really not as riskless as bank deposits, and the fact that MMFs were not insured by the federal government was of some consequence. Indeed, research has documented that MMFs had opportunities to take risk in the pursuit of higher yield during and after 2007, as the difference in yield between asset-backed commercial paper and Treasury bills rose to as high as 125 basis points, and that they indeed took advantage of these opportunities.[38]

Many major banks sponsor MMFs. Wells Fargo, the fourth-largest bank in the United States, has an MMF that manages $24 billion in assets, whereas Goldman Sachs, the fifth-largest bank, has one that manages $25 billion in assets. U.S. banks also operate MMFs in Europe. JP Morgan Chase has an MMF with €18 billion in assets, Blackrock has an MMF with €11.5 billion in assets, and Goldman Sachs has one with €10 billion in assets.

In addition to direct provisions of cash to banks, central banks have other ways of assisting banks. One way is by purchasing securities from banks. For example, between 2008 and 2014, the Fed purchased mortgage-backed securities worth $1.5 trillion. While

37. See Toussaint (2014).
38. See Kacperczyk and Schnabl (2013).

the ECB does not purchase securities in this manner, it permits member banks to use them as collateral against ECB loans to these banks, so the effect is similar. The ECB has also purchased covered bonds issued by private banks to finance their activities.

This leads to the following broad conclusions. First, the interventions of central banks to help stave off the failures of banks in their countries have many common elements. These interventions are, in fact, connected, since the central banks communicate with each other and often coordinate their actions (especially the ECB and the Fed). Second, central banks have invested massive amounts of resources in assisting their banks in order to limit systemic risk, which illustrates how the tension between the desire for financial stability and the desire to limit taxpayer support of banks has played out in practice. Third, while people often discuss the banking and shadow banking systems as if a bright red line divided them, quite a bit of shadow banking is actually embedded within traditional banks, and the conduct of central bank policy effectively provides resources to also support shadow banking institutions. Indeed, this support was quite explicit during the 2007–09 financial crisis as a run on MMFs prompted the U.S. government to intervene by providing unlimited insurance to all MMF investors, even though these investors' MMF accounts had no deposit insurance.[39] Finally, as research on financial system architecture has shown us, well-developed financial systems that are market-dominated (like in the United States) as opposed to bank-dominated (like in Europe) tend to be more innovative in creating new financial products to help to better manage risk and also more effectively support technological innovations in the real sector. Thus, while it is important to first develop robust and healthy banking systems, once the system is in place, then the more the architecture of the financial system leans on markets, the stronger and more vibrant the financial system becomes.

39. See Kacperczyk and Schnabl (2013).

HOW INTERNATIONAL BANK REGULATION WORKS

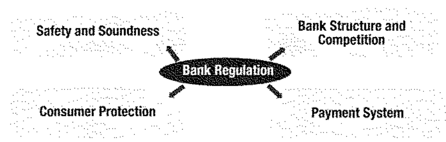
Both banks and markets are regulated in every country in the world. Before discussing how international regulation works—this section will focus on bank regulation—it is useful to consider why banks are regulated and the main areas in which they are regulated. This is the first topic addressed in this section. Then I turn to why we need international banking regulation. This is followed by a discussion of the specifics of European and U.S. bank regulation, and the main differences between the regulatory approaches, including those that can be attributed to the different financial system architectures in the two continents. I then briefly discuss the cumulative effect of bank regulation. The section concludes with a discussion of how excessive and poorly coordinated regulation can hurt economic growth.

Why Are Banks Regulated and What Is Regulated?

Banks are regulated for a variety of reasons, not the least of which is that because banks provide credit as well as payment services to the economy, the continued survival of banks is an important goal of most governments. Therefore, widespread bank failures are considered unacceptable, and governments provide deposit insurance as well as a host of other guarantees to protect banks. These guarantees, in turn, require regulations to ensure that banks' behavior does not increase the exposure of taxpayers who fund the safety net for banks, which then engenders a host of regulations.[40] *Figure 13* shows the different areas in which banks are regulated.

40. See Hall and Kaufman (2002) for a description of bank regulation goals.

Figure 13. Bank Regulation



Safety and Soundness: Banks are widely regarded as being more fragile than nonfinancial firms and thus more failure-prone. This is attributable to two main factors. First, a large fraction of a bank's financing comes from demand deposits, which can be withdrawn at a moment's notice; because we have *fractional reserve banking*,[41] the bank can fail even when its loans are in good standing. Second, banking failures are contagious because banks hold very similar assets, so the failure of one bank conveys adverse information about the asset portfolios of other banks.

For this reason, banks are subject to *prudential regulation*, which consists of regulatory requirements on capital, liquidity, and recovery and resolution planning. Banks are also subjected to stress tests by their central banks to determine how well they would stand up to adverse events. A key component of prudential regulation is a requirement stipulating how much equity capital a bank should keep as a percentage of its assets.

Bank Structure and Competition: Bank regulators seek to ensure that banking remains a reasonably competitive business, and excessive concentration is avoided.
The contemporary theory of financial intermediation indicates that banks are natural monopolies, so natural economic forces push banks to become larger.[42]

41. *Fractional reserve banking* means that at any point in time only a fraction of the bank's total deposits are kept in the bank as cash, so if all depositors wish to withdraw at one time, the banks would not have enough cash to satisfy all withdrawals.
42. See, for example, Ramakrishnan and Thakor (1984).

Regulators are concerned about banking concentration and bank size for at least three reasons. First, if the banking system is controlled by a few large banks, then noncompetitive pricing could occur and the bank customers could be worse off. Second, the larger the bank, the more costly is that bank's failure to society, so regulators identify banks that are "too big to fail" and make sure that public funds are used to protect these banks even beyond the de jure protection provided by deposit insurance. But if a bank gets too large, it may be "too big to save" because to save it may require funds that exceed the capacity of the country. For example, prior to the 2007–09 financial crisis, the five largest banks in Iceland collectively had assets that were five times the annual GDP of Iceland. Similarly, at one time, Barclays's total assets exceeded the GDP of the United Kingdom, where the bank is headquartered. To avoid such large exposures, regulators may wish to keep banks from becoming too large. Third, larger banks tend to be more complex, and more complex banks tend to exhibit greater interconnectedness with a variety of counterparties and with other banks. This makes it more challenging to regulate them. A key factor in the United States government's decision to come to the assistance of Bear Stearns was that it was in the center of a large and complex web of swap transactions.

In the future, regulatory requirements are likely to force radical structural changes, including possibly splitting up global entities into smaller, separately regulated subsidiaries.

Consumer Protection: Regulators fear that consumers' lack of financial sophistication may lead them to make poor choices when purchasing financial products and services. That is, regulators worry about a financial sophistication asymmetry that exists between banks and their customers. This asymmetry leads to regulators asking banks to more clearly, and in greater detail, provide information to consumers to enable them to make smarter choices. Such regulations are also intended to protect against fraud and misrepresentation. Additional regulations are designed to ensure equal access to credit for consumers regardless of characteristics like race, color, gender, or country of origin.

Payments System: In many countries, banks operate much of the retail and wholesale payments system through clearing the settlement of checks, credit and debit cards, and large-denomination electronic interbank transfers.[43] An efficient payments system is a key component of an advanced financial system because it enables smooth global flow of funds. However, once an efficient payments system is established, it is difficult to see an economic rationale for a lot of government intervention, beyond the central bank playing a lender-of-last-resort role to provide emergency liquidity to the banking system.

Why Do We Need International Banking Regulation?

The stresses experienced by banking systems in various countries in the 1980s made regulators realize that the interconnectedness of banks spanned national boundaries, so the traditional method of operating with independent national regulations was outdated. International harmonization of bank regulation was needed. This harmonization had another purpose: to increase the safety of the global financial system by reducing the likelihood of individual failures that could spread across national boundaries and become a global contagion. This safety was to be achieved by stipulating, for the first time, minimum risk-adjusted capital ratios that regulators in different countries had to adopt to ensure that the banks in their countries were sufficiently well capitalized. Each national regulator could choose to impose higher capital requirements, but not lower.

The design of the transnational regulations was delegated to a newly established Basel Committee on Banking Supervision, located in the Bank for International

43. See, for example, Hall and Kaufman (2002).

Settlements (BIS) in Basel, Switzerland, and it was comprised of representatives from central banks and banking regulators in developed countries.[44] The first capital accord (called Basel I) was completed in 1988 and was implemented by member countries by year-end 1992. The key was that bank assets were grouped in different categories based on (primarily credit) risk, and riskier assets had to be supported with more bank capital. Since then, refinements of Basel I, called Basel II and Basel III, have been formulated.

Specifics of American and European Bank Regulation

While many uncertainties still exist about the liquidity and leverage (or capital requirements) ratios that banks will be subject to as well as how risk-weighted assets will be implemented under Basel III, the direction of changes for both the liquidity and leverage ratios is to increase safety and soundness in banking. The Basel Committee has signed off on a revised approach to the liquidity coverage ratio, which is defined as the minimum amount of high-quality liquid assets the bank should hold to cover stressed cash outflows over a 30-day period. The leverage ratio is defined as the percentage of a bank's total adjusted assets accounted for by equity capital.[45] Regulators in many countries (including the United States) use the leverage ratio along with a ratio of capital to risk-adjusted assets[46] in their prudential regulation of banks.

Under Basel III, the minimum leverage ratio is 3%. While the ECB has continued to use this ratio, U.S. banks have been subjected to additional capital requirements based on stress tests of individual banks. This is one reason why there continue to be noticeable

44. See Greenbaum, Thakor, and Boot (forthcoming) for a discussion of the Basel capital accords.
45. Defined as capital plus reserves minus some intangible assets like goodwill software expenses and deferred taxes. Total adjusted assets are total assets minus intangibles.
46. Assets are risk-adjusted by assigning risk weights to different assets, with higher weights being assigned to riskier assets.

differences between the leverage ratios of European and U.S. banks, the other reason being different accounting standards. It has been suggested that bank regulators in both Europe and the United States have allowed banks to increase the fraction of debt in their capital structures—thereby reducing their leverage ratios—but the incentives were stronger in Europe because of "the permissive bank risk management practices epitomized in the Basel II proposals."[47] Because European regulators permitted banks to operate with lower amounts of capital, these banks expanded their balance sheets more rapidly than U.S. banks. European banks exhibited a preference for assets with low-risk weights, so they were able to report strong capital ratios under the Basel II framework.[48] Using this approach, the top global European banks like BNP Paribas, Barclays, Deutsche Bank, and Sociéte Generale all expanded their lending at an unprecedented rate from 1997 to 2008. By contrast, U.S. banks have been governed more by the Basel I capital guidelines, which resulted in higher capital ratios, and they tended to focus more on assets that had attractive expected returns.[49]

ANOTHER KEY DIFFERENCE BETWEEN EUROPE AND THE UNITED STATES LIES IN THEIR FINANCIAL ARCHITECTURES.

Another key difference between Europe and the United States lies in their financial architectures. As noted previously, the architecture of the European financial system is bank-dominated, whereas the architecture of the U.S. financial system is market-dominated. This means European firms are much more dependent on bank finance than U.S. firms. In the United States, asset managers are moving into the spaces vacated by banks, which is not the case in Europe, where undercapitalized banks with bloated

47. See Shin (2012).
48. See Avramova and Le Leslé (2012).
49. See Noeth and Sengupta (2012).

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CREATING A DEEP AND INTEGRATED EUROPEAN CAPITAL MARKET WITH THE DIVERSITY OF THE U.S. FINANCIAL MARKET WILL GO A LONG WAY IN HELPING THE EUROPEAN FINANCIAL SYSTEM TO BECOME MORE RESILIENT AND VIBRANT.

balance sheets many times larger than the European Union economy rely on assistance from the ECB and subsidies from national governments, and hold on to their share of the market. This impedes the allocation of capital to the best projects and hurts GDP growth, lengthening Europe's economic malaise. If Europe had a financial architecture more like that of the United States, European firms could shift to market finance to replace lost bank funding. Creating a deep and integrated European capital market with the diversity of the U.S. financial market[50] will go a long way in helping the European financial system to become more resilient and vibrant.

The Cumulative Impact of Bank Regulation on the Economy

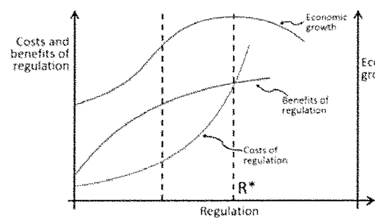
While a certain amount of bank regulation is necessary to maintain a safe and sound financial system that promotes economic growth, excessive regulation can impose costs that exceed the benefits of the regulation. The history of bank regulation is that it is usually enacted in response to a crisis, and then there is often an overreaction as the new regulation reaches too far and becomes excessively stringent. Since the 2007–09 crisis, a steady stream of new regulations have been enacted, and banks are seeking to reduce the added costs of the cumulative impact of regulatory reforms on the costs of funding, compliance, reporting, risk management, and governance.

The relationship between regulation and economic growth is nonmonotonic, as

50. See Thakor (2011).

shown in *Figure 14*.[51] Up to a point, call it R^*, regulation is good for economic growth. Up to this point, the benefits of regulation exceed the costs. Beyond R^*, the costs exceed the benefits and further regulation hurts economic growth.

Figure 14. The Relationship between Regulation and Economic Growth



How Excessive and Poorly Coordinated International Regulation Can Hurt Global Economic Growth

Owing to the shock waves produced by the global financial crisis of 2007–09, regulators the world over have become tougher in their regulation of banks and markets. However, as is typically the case, regulatory reforms adopted after a crisis tend to go too far. The 2007–09 crisis is no exception. Banks have been contracting their balance sheets, and this shrinkage has reduced the financing banks provide for their customers as well as their willingness to warehouse risks. Since this retrenchment has occurred in various types of relationship lending, market-based financing has not entirely filled the void created by the departure of traditional banks. Banks have also reduced their market-making

51. KPMG Financial Services (2014).

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activities in the securities market.[52] This has resulted in two consequences that are both inimical to economic growth: market volatility has increased, and thinly traded contracts are threatened with a potential shortage of liquidity. A sort of competitive tension has been created as European and U.S. regulators demonstrate their regulatory effectiveness in promoting financial stability. Thus, although much of the regulation coming out of Washington, D.C., and Brussels (European Union) is conceptually similar, conflicts do exist. For example, a regulatory push is under way to conduct more derivatives trading through clearinghouses. A large fraction of swaps activity is on a trans-Atlantic basis, and it would need to be done through a clearinghouse that is approved by European regulators. But it is unclear if any U.S. clearinghouses would qualify, which creates uncertainty. Another issue is the regulatory focus on geographically aligning the origin and management of risk; for example, requiring global banks to create Asian subsidiaries (incorporated in Asia) to house risks originated in Asia. This focus tends to create a Balkanization of global financial markets, with inefficiencies in institutional balance sheet management and higher costs of capital for financial institutions thereby reducing participation by banks in many markets.

The silver lining is that now the regulatory focus in both Europe and the United States is shifting from concerns about safety to a more balanced focus on safety as well as economic growth. This shift is especially important in Europe, where bank-based financing is still more important than market-based financing.

52. In the United States, this reduction is partly attributable to the adoption of the Volcker Rule. However, this rule is now also effectively being adopted by European regulators.

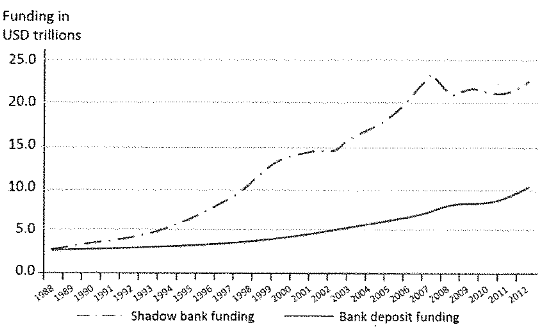
THE PROVISION OF MARKET-BASED FINANCE

Market-based financing has grown rapidly in the past decade. The term *shadow banking* somehow conjures images of illicit banking or banking in the "gray" economy. It is nothing of the sort. Indeed, market-based financing is very much a part of the mainstream financial system. "Shadow banking" is a term that was coined by economist Paul McCully in a talk at a conference in Jackson Hole, Wyoming, hosted by the Federal Reserve Bank of Kansas City in 2007. It refers to institutions that act like banks in the sense that they engage in *maturity transformation*—investing in assets with maturities longer than those of the liabilities that fund them—but they are not supervised like banks. While "shadow banks" do not finance themselves with short-maturity deposits like commercial banks do, they nonetheless raise short-term debt in the financial market through repurchase agreements or "repos."[53] Thus, broker-dealers who fund their assets using repos are "shadow banks". Similarly, money market mutual funds that pool investors' funds to purchase commercial paper or mortgage-backed securities, finance companies that sell commercial paper and extend credit to households and individuals are part of, the market-based financing system.[54] Insurance companies, hedge funds, and investment banks are also part of market-based financing.

53. As pointed out is Section II, a repo is an arrangement whereby an institution borrows short term from another institution, using marketable securities (Treasuries, mortgage-backed securities, etc.) as collateral. When the loan is repaid, the collateral is returned. Technically, the security is sold to the lender (so the price paid by the lender becomes the loan) and the loan repayment is considered a repurchase of the security by the borrower.
54. For discussions of shadow banking, see Kodres (2013) and Greenbaum, Thakor, and Boot (forthcoming).

Funding in the market-based financing sector has grown much faster than bank deposit funding, as shown in *Figure 15*.

Figure 15. Shadow Bank Funding and Traditional Bank Deposit Funding from 1988 to 2012



Market-based financing is therefore a much bigger sector of the U.S. financial system than traditional depository banking. The fact that not only was such a large sector not regulated like banks, but that there were no data on what was happening in this sector may have had something to do with the fact that regulators were caught off guard by the developments that triggered the financial crisis in the United States.[55]

Prior to the 2007–09 financial crisis, shadow banking entities were characterized by inadequate information disclosure about the values of their assets, opaque governance and ownership structures between banks and shadow banks, lack of regulatory oversight

55. See Gorton and Metrick (2010).

associated with traditional banks, little capital to absorb losses, and low cash levels to meet redemptions.[56] In May 2010, the Federal Reserve began collecting and publishing data on the part of the shadow banking system that deals with repo lending.

In 2012, the Financial stability Board conducted a global monitoring exercise to gather data that show that the U.S. market-based financing system is still the largest in the world, although its share globally has declined from 44% to 35%. The global market-based financing system rose to $62 trillion in 2007, declined during the crisis to $59 trillion, and then grew again to $67 trillion by year-end 2011, making its share of total financial intermediation about 25% in 2009–11.

While market-based financing performs some financial intermediation roles that may have been vacated by traditional banks, it is important to recognize that commercial banks get involved in market-based financing in various ways.[57] Perhaps the most obvious way is that commercial banks are owned by bank holding companies (BHCs). A BHC might own a wealth management unit with a money market mutual fund. Another example is that a commercial bank originates loans whose securitization creates securities that market-based financing institutions holds and then borrow against to use as collateral in repo transactions.

56. See Kodres (2013).
57. This discussion is based, in part, on Greenbaum, Thakor, and Boot (forthcoming).

CONCLUSION

The global financial system is vast and global flows within this system have an enormous effect on the real economies of different countries; that is, on GDP, economic growth, and the well-being of individuals.

- The global financial system is vast and consists of financial institutions (banks and shadow banks) as well as financial markets in stocks, bonds, commodities, and derivatives.
- The global financial system promotes economic growth by performing key functions that facilitate and enhance the flow of capital from savers to investors, and increase the set of opportunities to individuals and businesses.
- The global financial system is highly interconnected. This interconnectedness increases the complexity of international regulation harmonization, while simultaneously increasing the need for it. If regulation is not harmonized across national boundaries, regulatory arbitrage may occur as banks from more tightly regulated domains seek to escape to those with more lax regulation. This may then lead to an increase in financial risk in the domain with lax regulation, but global interconnectedness may cause this risk to spill over elsewhere, increasing global systemic risk. Thus, regulators must be cognizant of the fact that any change in regulation in one part of the global financial system is likely to have global ripple effects.
- Firms tap the global financial markets to raise capital and the depth and liquidity of the global financial market help companies reduce their cost of capital and improve access to funds, thereby facilitating investments and

growth. Thus, better-developed global financial markets spur entrepreneurship, investment, employment growth, and continued rise in GDP.

- The global financial system promotes global trade through financing mechanisms outside the banking system, through trade credit, which is credit extended by firms to their customers. Trade credit is large in magnitude and increases with the size of global trade flows. Moreover, the magnitude of trade credit is positively affected by the development of the global financial system.
- Project financing has been creatively used to finance large-scale projects. It has often involved private-public partnerships in which governments are able to get private companies to build public infrastructure.
- Financial architecture refers to the composition of a financial system, namely the relative importance of banks and markets in allocating capital. Roughly speaking, financial systems fall into two broad categories—bank-dominated and market-dominated. Market-dominated financial systems seem to be associated with a higher rate of technological change, but regardless of whether a financial system is bank-dominated or market-dominated, development of the financial system promotes economic growth.
- Banks as well as financial markets are subject to regulation, and in both cases regulators face tensions in enforcing regulations that pull in opposite directions. Regulatory actions to achieve financial stability create greater interconnectedness in the financial system.
- Bank regulation has multiple goals, and it is being increasingly harmonized, but the danger is that regulation may go too far. While regulation boosts economic

growth to a point, beyond that point it reduces growth as the costs for banks to comply with regulation exceed its benefits to society.

- Shadow banking refers to maturity transformation being conducted by financial intermediaries other than traditional commercial banks, such as MMFs, investment banks, and hedge funds. This sector of the financial system has grown faster than depository banking in recent years and is now bigger than traditional banking in the United States. However, it provides valuable services to Main Street, including households, and traditional commercial banks also play a role in shadow banking.

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RAYMOND JAMES.

June 25, 2015

Chairman Jeb Hensarling
Financial Services Committee
2129 Rayburn HOB
Washington, DC 20515

The Honorable Jeb Hensarling,

In response to oral testimony submitted during the June 16, 2015 Capital Markets and Government Sponsored Enterprises hearing entitled "Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities," Raymond James would like to submit the following statement for the record.

While Raymond James has for some time been in favor of a common fiduciary standard, it is our opinion that the current Department of Labor proposal is overly complex, vague and costly to the point that it is not workable. We are aware of the fact that comments were made at the June 16th Financial Services Capital Markets committee meeting that implied that we did not think that there were significant issues with this proposal. We want to make it clear for the public record that these comments, while limited to a specific product category, do not accurately reflect the position of our firm.

Sincerely,

Scott Stolz
Senior Vice President
Private Client Group Investment Products

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Consumer Federation of America

AMERICANS FOR FINANCIAL REFORM

June 16, 2015

The Honorable Jeb Hensarling, Chairman
The Honorable Maxine Waters, Ranking Member
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters:

This week the Capital Markets and Government Sponsored Enterprises Subcommittee has scheduled a hearing at which it will consider legislation (H.R. 2187) that would dramatically expand the categories of individuals who are permitted to invest in private offerings issued under Regulation D of the securities laws. We are writing on behalf of the Consumer Federation of America (CFA)[1] and Americans for Financial Reform (AFR) [2] to express our strong opposition to the legislation as currently drafted.

The accredited investor definition plays an important role in defining the boundary between public and private offerings. Its purpose is to ensure that private offerings are sold only to those individuals who can fend for themselves without the protections of the public markets, including full disclosure of all material facts about the offering. As such, it is a crucial protection for ordinary Americans seeking to safeguard their investment capital, and a linchpin of the SEC disclosure regime that has been central to our securities markets since the 1930s.

There are a number of ways in which the accredited investor definition could and should be updated and improved. Changes designed to enable certain knowledgeable and experienced investment professionals and individuals to become accredited investors could be included in any such revisions.

Unfortunately, as currently drafted, HR 2187 serves not to reform the accredited investor definition, but to undermine and greatly weaken it. This legislation would thus unacceptably increase the risk that individuals without the financial expertise to understand the risks of unregistered offerings or the financial wherewithal to withstand potential losses would be exploited by unscrupulous individuals seeking to profit at investor expense.

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[1] CFA is an association of nearly 280 nonprofit consumer organizations that was established in 1968 to advance the consumer interest through research, advocacy and education.

[2] Americans for Financial Reform is a nonpartisan and nonprofit coalition of more than 200 civil rights, consumer, labor, business, investor, faith-based, and civic and community groups. Formed in the wake of the 2008 crisis, AFR works to lay the foundation for a strong, stable, and ethical financial system – one that serves the economy and the nation as a whole

H.R. 2187 is entitled the "Fair Investment Opportunities for Professional Experts Act," but its scope is much broader. Not only would it allow individuals who self-certify that they are broker-dealers, investment advisers, licensed attorneys or certified public accountants to qualify as accredited investors, but it would also define as an accredited investor any individual who self-certifies that he or she "has retained and used the services" of such an individual to make an investment in a Reg D offering. In addition, the legislation directs the SEC to establish an exam that individuals who do not meet the income and net worth thresholds could take to become licensed as an accredited investor As discussed below, each of these provisions is seriously flawed.

Demonstrated relevant knowledge and expertise in financial matters may a reasonable basis for considering exceptions to net worth requirements, but that is not in fact the standard that the bill proposes. Many of the individuals permitted to self-certify under this bill could lack relevant knowledge and expertise in financial matters. Broker-dealers and investment advisers who pass securities licensing exams and are legally qualified to recommend such offerings to their customers can presumably be trusted to determine whether such investments are appropriate for themselves. However, it is unclear why one would believe that *any* licensed attorney or CPA would be similarly qualified. For example, a securities attorney would have vastly different qualifications in this regard than an attorney who specialized in personal injury lawsuits. An auditor would likely have far greater expertise than a CPA whose practice consists of income tax preparation.

Even more troubling, however, is the provision that would allow any individual, regardless of income, net worth or financial sophistication, to qualify as an accredited investor simply by virtue of retaining and using the services of a broker-dealer, an investment adviser, a licensed attorney, or a CPA. We are open to the concept of allowing individuals to qualify as accredited investors by virtue of relying on the advice of a financial professional *subject to appropriate conditions*. But this legislation fails to impose any such conditions. It therefore risks exposing unsophisticated investors to exploitation by individuals who may themselves lack the requisite expertise and many of whom are not even subject to securities laws.

Any attempt to expand the accredited investor definition to permit reliance on outside advice would, at a minimum, have to specifically require that:

1) the purchase is made in reliance on *advice* from a registered investment adviser or broker-dealer,
2) that the advice is delivered under a *fiduciary standard* of care and *in the best interests of the client*,
3) and that the investment adviser or broker-dealer offering the advice *does not have a material financial stake* in the investment being recommended.

Such conditions are necessary to help ensure that private offerings are sold only to those for whom they are an appropriate investment as part of a diversified portfolio and under circumstances in which securities regulators can oversee that advice to verify that the interests of investors are protected.

Although we question how widely it would be used, we have no objection in principle to the proposition that experienced investors could qualify as accredited based on criteria including successful completion of an exam demonstrating the requisite expertise. For this approach to be acceptable, the test would have to be rigorous enough to indicate a reasonable level of financial expertise. In order to ensure that the individual has practical as well as book knowledge, it should be combined with a requirement that the individual have relevant professional experience or experience as an investor. Among other things, this would create a mechanism for licensed attorneys and CPAs who wish to qualify as accredited investors without meeting the financial thresholds in existing rules to do so without giving them a blanket accreditation. It is entirely unreasonable, however, to suggest that the SEC could adopt such a test within the six-month time frame provided under the statute.

Finally, the legislation relies extensively on individuals to self-certify that they meet the standards. But none of the criterion established in the legislation – from status as a licensed professional to successful completion of an exam – would be difficult to verify. The legislation should be amended to require verification, rather than self-certification, to provide an additional assurance that the provisions will not be gamed.

H.R. 2187 does not adequately ensure that all those classified as accredited investors under its terms would have the requisite knowledge and expertise to legitimately qualify as an accredited investor. In particular, its provision enabling individuals to qualify simply by virtue of retaining and using a financial professional, without any additional conditions or protections, would open these individuals to exploitation and abuse which securities regulators would in many cases be powerless to prevent.

We therefore urge you to reject this legislation. While we believe that the approach in this legislation is fatally flawed, we stand ready to help devise a legislative approach that would serve to enable sophisticated investors to qualify as accredited investors without opening the doors to exploitation of more vulnerable individuals.

Sincerely,

Lisa Donner
Executive Director
Americans for Financial Reform

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Cc: Members of the House Financial Services Committee

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NASAA

June 15, 2015

The Honorable Scott Garrett
Chairman
House Committee on Financial Services
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Committee on Financial Services
Washington, D.C. 20515

Re: June 16, 2015 Hearing of the House Financial Services Subcommittee on Capital Markets

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I write to offer comment on legislation that will be the subject of a legislative hearing in the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises tomorrow.

(1) The Fair Investment Opportunities for Professional Experts Act (H.R. 2187)

The Fair Investment Opportunities for Professional Experts Act would expand the number of persons who qualify as accredited investors, as that term is currently defined by the Securities and Exchange Commission ("Commission" or "SEC") pursuant to Rule 501 of Regulation D. The list of accredited investors, currently, includes: (i) any natural person whose individual net worth, or joint net worth with that person's spouse at the time of his purchase, exceeds $1,000,000 (with exclusions related to the value of the person's primary residence) or (ii) any natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

The Fair Investment Opportunities for Professional Experts Act expands the categories of persons treated as accredited investors under Rule 501, but without regard to income or net worth, to include: (i) registered broker-dealers, SEC-registered investment advisers, attorneys, and accountants; (ii) persons who use the services of a registered broker-dealer to make an investment decision regarding the securities being offered; and (iii) any person "licensed"[2] as an accredited investor by the Financial Industry Regulatory Authority ("FINRA") by virtue of having passed a test conforming to criteria established by the SEC. Further, in order to establish an individual's accredited status under the new categories, the bill would permit what amounts to "self-certification," requiring only that the purchaser "certifies to the issuer prior to the sale of securities to such person that he" is an accredited investor.

[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] H.R. 2187 purports to establish processes under which an individual may become "licensed as an accredited investor by the Financial Industry Regulatory Authority." However, as a self-regulatory organization, FINRA lacks authority to issue any such license. NASAA recommends that this provision be clarified.

President: William Beatty (Washington)
President-Elect: Judith M. Shaw (Maine)
Past-President: Andrea Seidt (Ohio)
Acting Executive Director: Joseph Brady
Secretary: Kathryn Daniels (Ontario)
Treasurer: Michael Rothman (Minnesota)
Ombudsman: Keith Woodwell (Utah)
Directors: Joseph P. Borg (Alabama)
Melanie Senter Lubin (Maryland)
John Morgan (Texas)
Gerald Rome (Colorado)

As the Subcommittee is aware, NASAA has long advocated for updating and improving the accredited investor standard in the interest of investor protection.[3] The current income and net worth standards were established in 1982, and have not been adjusted for inflation. In that regard, while we appreciate that H.R. 2187 recognizes a need to modernize the standard, we have serious concerns about the approach taken under the bill.

The legislation's foundational premise – that any person simply holding a specified educational requirement or professional designation should be deemed an accredited investor – is problematic. This approach fails to consider other important factors, such as the person's actual investment experience, net worth, or bona fide financial sophistication. NASAA acknowledges the potential for correlation between a person's professional training and their financial sophistication, but urges Congress to exercise great caution in considering legislation that would deem factors such as completion of a state bar exam or FINRA financial exam as, by themselves, sufficient grounds to establish in all cases an individual's ability to fend for his or her own interests in an opaque, illiquid marketplace, such as exists for Regulation D, Rule 506 securities.[4]

NASAA has similar concerns regarding the provisions of the bill that would award accredited status to *any* investor who has retained and used the services of a registered broker-dealer to make an investment decision irrespective of relevant criterion such as the investor's financial sophistication. Indeed, because many retail investors in the United States rely upon the services of broker-dealers when buying and selling securities, the practical effect of such a provision would be to immediately "deem" such individuals to be accredited investors, thereby exposing a potentially enormous new population of retail investors to the acknowledged risks inherent in investing in private, unlisted securities.

Finally, NASAA has significant concern regarding the bill's requirement for the development of a new test that would permit individuals to be "licensed" as accredited irrespective of any other factor or circumstance. While NASAA acknowledges that such a test, properly constructed and administered, could prove to be a useful tool for measuring some aspects of an investor's financial sophistication, we also note that accredited status is generally understood to denote more than mere conceptual mastery of skills like those that may be tested by examination. Indeed, as the SEC's Investor Advisory Committee recently noted in its recommendation regarding the accredited investor definition:

> "Over the years, analysis of whether a particular class of individuals needs the protections of the [Securities] Act has generally turned on three factors: 1) whether the individuals have (or are able to negotiate) access "to the same kind of information that the [Securities] Act would make available in the form of a registration statement;" 2) whether the individuals can bear the economic risks of the offering, including risks associated with the illiquidity of private offerings and the risk of loss; and 3) whether the individuals are sufficiently financially sophisticated, based on their knowledge and experience and in particular their ability to evaluate risks and

---

[3] See: Comment letter of Joseph Borg, NASAA President and Alabama Securities Commissioner, regarding Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles; Securities Act Release No. 33-8766; Investment Advisers Act Release No. 2576, 72 FR 400 (Jan. 4, 2007)

[4] Private offerings inherently have limited secondary market liquidity, and the pricing of such securities is less transparent since they are not traded in the public securities market. In addition, the initial and on-going disclosure obligations of the issuers of such securities are not subject to the same Commission rules, but rather are determined exclusively by the issuer or are subject to negotiation and agreement between the issuer and the investor. These attributes make private investments more appropriate for sophisticated investors who understand these risks and have the ability to negotiate access to information. *See:* Recommendation of the SEC Investor Advisory Committee: Accredited Investor Definition. (Oct 9, 2014.) Available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf

merits, to make an informed investment decision without the full disclosure provided in a public offering."[5]

In NASAA's view, absent the consideration of additional factors, it is difficult to understand how a test administered by FINRA could qualify major components of the accredited investor standard. It is unclear how such a test could reliably establish an individual's actual ability to "negotiate access" to "the same kind of information that the [Securities] Act would make available," or discern whether such individual is in a position to "bear the economic risks of the offering, including risks associated with the illiquidity of private offerings and the risk of loss." Again, NASAA appreciates that such an examination could yield information pertinent to the question of whether individuals are financially sophisticated, based on their knowledge. However, we believe that *actual experience,* taking into consideration the investments owned by an investor, is the best indicator in this regard.[6]

Although NASAA disagrees with certain aspects of H.R. 2187, state securities regulators share and support Congress's general interest in revisiting and updating the accredited investor standard. As a first step, NASAA would strongly encourage Congress to support the SEC's effort to gather information about the Regulation D private-placement market, about which remarkably little is known, despite its rivaling the public markets in size.[7] Specifically, Congress should urge the SEC to adopt the rules proposed in July, 2013, that would require additional disclosures by issuers selling securities in reliance on Rule 506, including filings of Form D, both preceding, and subsequent to the offering.[8] These rules are essential and already long overdue.

Finally, NASAA would also note that the Dodd-Frank Act requires the SEC to undertake a review of the accredited investor definition in its entirety as it relates to natural persons every four years, beginning in 2014. The SEC staff is in the midst of conducting a comprehensive review of this definition, and as of June 12, 2015, approximately 413 comment letters dealing with the accredited definition had been received.[9] In NASAA's view, given the scope of the SEC's review and the fact that it is already well underway, Congress should await the results and recommendations prior to making the substantial changes contemplated by H.R. 2187.

(2) <u>The Small Business Credit Availability Act</u> (Discussion Draft)

Today, the Subcommittee will also consider a discussion draft bill ("bill" or "proposed bill") that 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.[10]

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[5] Recommendation of the SEC Investor Advisory Committee. The Accredited Investor Definition. https://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf

[6] NASAA has long advocated in favor of an "investments owned" test as an alternative basis for determining accredited investor status in addition to the existing net worth and income standards. We note that SEC proposed a form of "investments owned" test as an alternative basis for determining accredited investor status in 2007. (Securities Act Release 33-8828)

[7] As the Commission noted in the release for the final rule lifting the ban on general solicitation in Rule 506 offerings, it has "relatively little information on the types and number of investors in Rule 506 offerings."

[8] The SEC's Proposing Release notes that the pre-filing requirement is intended, in part, to enhance the SEC's understanding of the Rule 506 market by improving compliance with Form D filing requirements. See, SEC Release 33-9416, 34-69960, IC-30595, Amendments to Regulation D, Form D and Rule 156 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013). http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm

[9] See: Comments on Proposed Rule: Amendments to Regulation D, Form D and Rule 156 under the Securities Act [Release Nos. 33-9416, 34-69960, IC-30595; File No. S7-06-13]. Available at: http://www.sec.gov/comments/s7-06-13/s70613.shtml

[10] 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/.

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.[11] In addition, under Section 12(d)(3) of the ICA, a BDC 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.

The proposed bill contains significant conflicts of interest. Specifically, Section 2(a) of the bill would remove prohibitions on the ability of BDCs to invest in investment advisers and financial companies. 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 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

[11] 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.

[12] Congress should, at a minimum, require the SEC to adopt rules addressing any potential conflicts prior to permitting this investment.

who would bear the loss if the BDC invested in riskier products such as payday lenders and installment programs, REITS, or other structured products.[13]

Section 3: Expanding Access to Capital for Business Development Companies

In 2013, NASAA testified that it questioned the rationale for further relaxing the leverage limits applicable to BDCs.[14] 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 2013 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.[15] 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,[16] 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

[13] 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.

[14] 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.

[15] 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.

[16] 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.

create for retail investors, and examine what if any steps can be taken to mitigate such risks.[17] 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. 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 3(a)(5) of the bill provides extensive relief from voting rights requirements and the right to elect directors in the event of default except in certain instances. Congress should consider whether the relief should also be inapplicable to issuances of debt to investors that are not qualified institutional buyers. Finally, Section 3(a)(5) of the bill contains language that would allow BDCs to issue multiple classes of debt securities and senior equity securities, which would dilute the value of common stock. We encourage Congress to require that if additional preferred stock is allowed, that it be counted as debt and not as equity.

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.

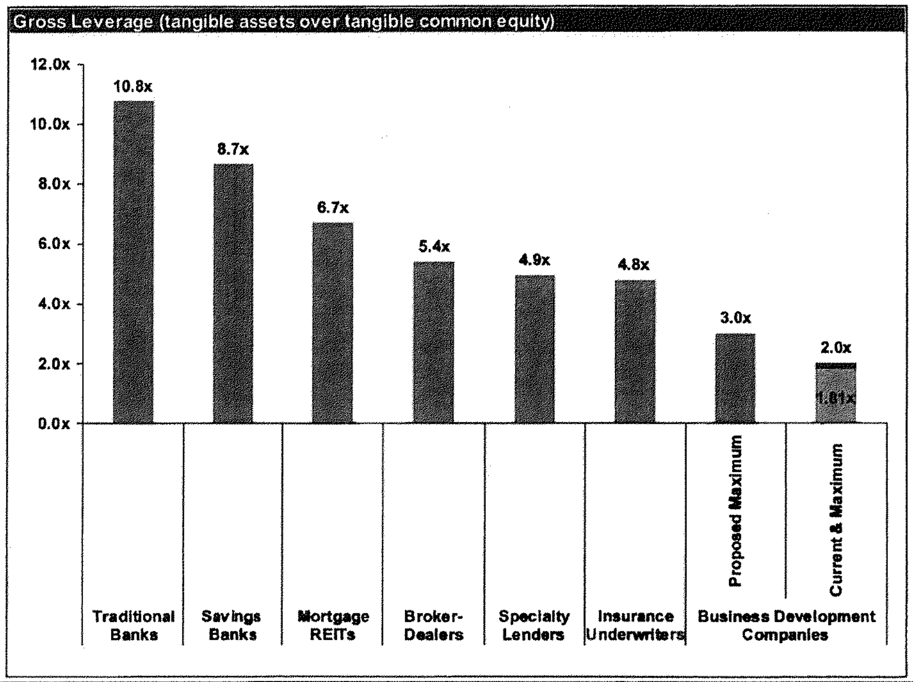
Thank you for considering NASAA's views on the legislation before the subcommittee. State securities regulators look forward to working with Congress on these and similar efforts to promote efficient capital formation and modernized investor protection frameworks. Should you have any questions, please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

Sincerely,

William Beatty
NASAA President
Washington Securities Administrator

[17] 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.

Leverage across Financial Services Industries



Based on most recently reported results across a sampling of ~1,300 financial services firms. For BDCs, leverage is commonly expressed as a debt-to-equity ratio of less than 1x. A debt-to-equity ratio of 1x is equivalent to a gross leverage ratio of 2x. Source: SNL Financial

PROSPECT

Testimony Submitted by Joseph Ferraro,
General Counsel, Prospect Capital Corporation
before
The House Subcommittee on Capital Markets
and Government Sponsored Enterprises
on
"Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities"
June 16, 2015

Mr. Chairman, Ranking and Members of the Committee, thank you for the opportunity to submit this written testimony. My name is Joseph Ferraro and I am General Counsel to Prospect Capital, a leading provider of capital to job-creating small and medium-sized companies in the United States. Prospect Capital strongly supports Congressman Mulvaney's "Small Business Credit Availability Act."

I. Prospect Capital Corporation

Prospect is a publicly-traded business development company. A business development company is a closed-end investment company that focuses on investing in small- and medium-sized private companies rather than large public companies. Our company completed its initial public offering in July 2004, and since then we have invested more than $10 billion in over 200 small- and medium-sized companies. Prospect is a growing company whose operations utilize over 100 employees in 4 locations – New York, Houston, San Francisco and Darien, Connecticut.

Prospect invests primarily in first-lien and second-lien senior loans and mezzanine debt, which in some cases include an equity component. Our flexible mandate allows Prospect to provide capital to small- and medium-sized companies for re-financings, leveraged buyouts, acquisitions, recapitalizations, later-stage growth investments, and capital expenditures.

Small- and medium-sized companies use capital from Prospect to expand their businesses, hire workers, construct factories, and achieve other important objectives. Prospect's portfolio is diversified across a wide variety of industries – about 50 in total – including manufacturing, industrials, energy, business services, financial services, food, healthcare, and media. The small- and medium-sized companies we finance employ more than 100,000 American workers in nearly every state in the nation.

From the perspective of our shareholders, our investment objective is to generate both current income and long-term capital appreciation through debt and equity investments.

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Prospect seeks to maximize returns and minimize risk for our investors by applying rigorous credit analysis to make and monitor our investments small- and medium-sized companies.

We are proud of our track record supporting scores of small- and medium-sized companies that we have helped grow over time. In the current calendar year we have already closed more than $430 million of investments, and we have closed about $1.79 billion of originations in the past twelve months. Our capital has helped create thousands of American jobs over the years, and our capital is much needed in this critical period of high unemployment and economic uncertainty.

II. Business Development Companies

In 1980, Congress enacted amendments to the Investment Company Act of 1940 authorizing business development companies (BDCs). Congress wanted to facilitate private finance investment at a time when, much like today, bank balance sheets were reeling from a period of economic largesse in the 1970s, and small- and medium-sized American businesses faced limited credit options. In response, Congress authorized a publicly traded, closed-end fund structure, the sole intent of which was to facilitate private finance investment to small- and medium-sized American businesses while offering such homegrown businesses significant guidance and counseling concerning management, operations, business objectives, and policies. Put simply, a BDC is a lender to and investor in small- and medium-sized businesses and has stepped into a role commercial banks have largely abandoned – lending to small- and medium-sized American businesses that might not otherwise obtain financing to grow.

BDCs must invest at least 70% of their assets in so-called "eligible assets." The most common types of "eligible assets" are private and "micro-cap" public American companies. These investments must be privately negotiated and the BDC is required to offer managerial assistance to these companies in which the BDC invests to meet specific business challenges.

Small- and medium-sized American companies generally face difficulty in meeting their capital needs.

And why is that?

On the one hand, generally such companies are too small to afford the expense of directly accessing the public debt and equity markets. On the other hand, their capital needs are frequently too large to be well served by SBA programs or small community banks. These small- and medium-sized companies generally require $10 million or more in incremental financing.

Financing these companies requires significant time and energy by the lender or capital provider, including due diligence activities and rigorous credit analysis that have become uneconomical for traditional banks, with transaction sizes that are too small for many other capital providers.

Thus, for small- and medium-sized companies BDCs represent a very important source of capital. Our industry today is composed of about 50 publicly traded BDCs collectively managing $63.8 billion in assets (up from $11.6 billion in 2004) with an aggregate market capitalization of $34.55 billion. BDCs have become an integral part of the credit markets.

BDCs are heavily regulated. They are public companies that are subject to the Securities Act of 1933 and file an election with the SEC to also become subject to the Investment Company Act of 1940. Thus, BDCs are transparent vehicles both for investors and for small- and medium-sized American companies seeking capital. For example, BDCs file the same periodic reports with the SEC as any other public company, while also being subject to the additional regulatory constraints of the Investment Company Act of 1940.

The shareholders of BDCs, many of them retirees on a fixed income, receive the investor protections of our securities laws while having an opportunity to participate in the types of investments that otherwise are only available to deep-pocket investors through private partnerships. BDCs also offer advantages to the companies that are in need of investment capital to grow. For many of the companies in which a BDC invests, traditional sources of financing like bank lending or public offerings are unavailable. For these companies, BDCs offer an alternative source of capital that is subject to public disclosure and transparency.

In summary, BDCs provide substantial benefits to the American economy, including the opportunity for the investing public to invest in smaller growing businesses and the opportunity for such small- and medium-sized companies to obtain much-needed financing.

III. Common Sense Modernization

Mr. Chairman and Members of the Committee, we believe that modest changes to our securities laws can greatly enhance the benefits offered by BDCs to the American economy and allow BDCs to better serve the capital needs of small- and medium-sized companies. Our industry already helps to create many American jobs, and if Congress modernizes some of the rules under which we operate I believe that we will be able to create many, many more.

The changes the industry welcomes have been recommended in legislation introduced in the last Congress by both Republicans and Democrats and are reflected in the current discussion draft. We appreciate not only the efforts of these Members and those who have cosponsored and supported these bills, but also this Committee's actions in prior years to modernize the rules under which BDCs must operate. Your bipartisan efforts have made BDCs more efficient and the regulations that we operate under more responsive to the needs of both our investors and the small- and medium-sized companies that we serve. This was true in the "National Securities Markets Improvement Act of 1996" when Congress modified the definition of eligible portfolio company and made other adjustments to the original 1980 law. And it was true in 2004 and 2005 when this Committee moved legislation to further improve the definition of eligible portfolio companies.

Today, I would like to urge the Committee to consider some additional steps that can be taken to help make BDCs even more robust capital providers to small- and medium-sized companies, thereby helping with American job creation in this period of high unemployment. A few modest reforms to our securities laws, as reflected in the Committee's discussion draft, can help every BDC more effectively achieve their purpose without undermining investor protections.

(1) Further Update the Definition of Eligible Portfolio Company

Registered investment companies are allowed to invest in financial services companies, including community banks, leasing companies, factoring firms, and automobile financing companies. However, as described above, BDCs must invest at least 70% of their assets in "eligible portfolio companies." When Congress created BDCs, it focused on industry and services, but excluded financial services companies from qualifying as "eligible portfolio companies." Thus, no more than 30% of a BDC's assets can be invested in financial companies. This limitation makes no sense decades later given the substantial growth of financial services as a leading job provider in the American economy since 1980. Financial services companies employ millions of American workers and have a capital magnifying effect that results in more capital flowing into small- and medium-sized American businesses.

A policy that limits BDC investments in small- and medium-sized financial services companies runs counter to the objective of helping attract capital for the benefit of small- and medium-sized American companies. In fact, frequently such companies in turn serve the financial services needs of other, smaller companies. For example, we have one company in our portfolio called Nationwide Acceptance. Based in Chicago, Nationwide provides capital to Americans with modest means in order for such individuals to purchase automobiles that those individuals need to get to and from work, drive their children to after-school activities, and pursue their individual transportation freedoms. BDCs should not have limits on providing capital to such important companies. Financial service companies serve a vital role in our economy and should be encouraged, not stifled.

Financial businesses that are subject to the current law limitation are comprised of a wide array of companies: community banks, insurance and reinsurance businesses, asset and investment advisors, real estate businesses, industrial loan companies, consumer financing businesses, credit card receivables companies, business inventory and receivables financing companies, automobile financing businesses, equipment financing businesses, companies making loans to purchase livestock feed and farm products, companies owning or holding oil, gas or mineral leases or royalty interests, and many more. Again, these types of companies amplify the amount of capital made available to small- and medium-sized American businesses and American consumers, thereby helping with economic stimulation and job creation at no cost to the federal government.

The original justification for Congress back in 1980 limiting a BDC's level of investment in financial companies is not clear. I believe that this old part of the law is painfully antiquated and arbitrary. BDC investments in small- to medium-sized American financial services businesses are consistent with the principal purpose for which Congress created

BDCs – to provide capital and assistance to small, developing businesses that are seeking to expand and create American jobs.

Last Congress the Committee voted to report legislation that treated financial service companies described in section 3(c)(2), (3), (4), (5), (6) or (9) of the Investment Company Act of 1940 as eligible portfolio companies. Such legislation would allow BDCs to treat as an eligible portfolio company an investment in financial service companies such as equipment leasing companies, factoring companies, and similar entities. We continue to support these suggested changes to the Investment Company Act of 1940.

The reported legislation excluded entities described in section 3(c)(1) and (7) of the Investment Company Act of 1940, thus maintaining the current law exclusion of investments in private investment vehicles (e.g., private equity, hedge funds, collateralized debt obligations, etc.) that can only be sold to qualified investors from the definition of eligible portfolio company (the so-called "70% basket"). We continue to support such exclusion, and the proposal to cap the total amount of investments in any entity described in section 3(c) of the Investment Company Act of 1940 to 50% of BDC total assets. We believe that such a cap would still make the reform meaningful and would further the objectives I have described above.

(2) Update 1940 Act's limitations on owning investment advisors

The Investment Company Act of 1940 prohibits a BDC from acquiring more than 5% of any class of equity securities or more than 10% of the total debt securities of (or invest more than 5% of its assets in) any company that directly or indirectly derives more than 15% of its consolidated gross revenues from securities-related activities including acting as a registered investment advisor. Thus the 1940 Act limits the ability of a BDC to invest in investment advisers.

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, an investment adviser having fewer than 15 clients could generally avoid registration under the Investment Advisers Act of 1940, and BDCs could and did invest in unregistered investment advisers. BDCs typically used this flexibility to form and manage captive investment advisers that would manage investments on behalf of third party investors or the BDC itself, permitting stockholders in the BDC to benefit from the stream of advisory fees generated by such investment advisers. Following implementation of the Dodd-Frank Act, which repealed this registration exemption for "private advisers," BDCs owning (or wishing to acquire) a registered investment adviser must apply to the SEC for exemptive relief. Although the SEC has provided administrative relief from this prohibition through several exemptive relief orders, the process is very time consuming and expensive.

The discussion draft would modernize the statute by repealing this prohibition and end the needless spending of shareholder resources to seek administrative relief. In essence, it simply codifies existing practice, removes unnecessary costs and levels the playing field between those BDCs that have been granted exemptive relief and those that have not. Changing the law here also reflects that asset management companies are no riskier, and arguably less risky, than many other parts of the economy. Such companies also employ plenty of American workers, and their growth should be encouraged rather than discouraged.

(3) Modernize and Re-examine the Restrictions on How BDCs Raise Capital

Last Congress the Committee acted favorably in voting to report out some common sense reforms on how BDCs raise capital in the market. Reducing the cost of raising capital benefits both BDC shareholders and the small- and medium-sized American companies in which they invest. These changes are also contained in the discussion draft.

(A) Shelf Registration Forms

BDCs, like other companies that regularly raise capital through securities issuances, rely on pre-filed "shelf registration" – a securities filing that allows a company to be prepositioned to issue additional securities. Because shelf registrations contain financial information that becomes outdated as companies publicly report their most recent financial information, companies are allowed to incorporate by reference in their shelf registrations subsequent financial reports. However, BDCs are not allowed to take advantage of this common sense approach, and instead we must manually update our shelf registration statements ***each time*** we report new quarterly information. This slows down the timetable for a BDC to access the capital markets and adds the unnecessary expense of lawyers, accountants and printers to the securities offering process.

Why must BDCs replicate the information in duplicative public filings at needless cost and with no known investor benefit?

Why must we file the electronic equivalent of reams of duplicative paper?

Dr. Seuss' Lorax famously asked: "who speaks for the trees?" The pending legislative initiatives properly ask: "who speaks for common sense?"

The measure considered last Congress would require the SEC to reform the forms and instructions for shelf registrations to treat BDCs like other companies eligible to use shelf registration statements. BDCs currently must copy and paste entire documents over and over again into filings, thereby requiring armies of lawyers, accountants, and printers. Every other type of public company in America has more streamlined rules reflecting the electronic age. BDCs should have access to the same streamlined filing benefits.

(B) Offering Reform

BDCs can only offer additional capital to small- and medium-sized American companies when we can increase our own capital. Our industry is traditionally a frequent issuer of new securities offerings to raise such funds. For example, Prospect has raised over $3.5 billion since our IPO in 2004 through equity offerings.

In 2005 the SEC modernized the issuance process for frequent issuers, reducing costs and making the process more efficient. However, BDCs were excluded from these common sense reforms, with a promise that the issue would be revisited. A decade later nothing has happened. This situation has not benefited the capital needs of small- and medium-sized companies, nor has it provided any beneficial investor protections. It is time that our business development companies have the same access to the capital markets as enjoyed by other publicly traded companies.

For example, the offering reforms recognize companies that are "Well-Known Seasoned Issuers" or "WKSIs." These are companies that generally are frequent issuers in the public markets and have significant market capitalization. Generally, WKSIs can take advantage of new, liberalized rules relating to communications with investors and the registration process. Unfortunately BDCs were explicitly excluded from the definition of WKSI without any explanation or rationale.

In fact, BDCs are the only industry disadvantaged by offering reform.

How?

Offering reform allows issuers greater freedom to communicate with prospective purchasers. One such method that is allowed is a recorded electronic road show that is played on a delayed basis. Before offering reform, BDCs and other issuers relied on a series of no-action letters issued by the SEC to use electronic road shows. As part of the reform, the SEC withdrew the electronic road show no-action letters. As a result, BDCs are no longer permitted to use or disseminate recorded copies of electronic road shows and were not made eligible for the new modernized communication rules.

There is no public policy justification for BDCs being left behind when the SEC modernized the rules that govern how companies can raise capital in the public markets, nor to have an otherwise constructive modernization effort inadvertently turn the clock back on our industry.

(C) Leverage Limitation and Preferred Shares

The Investment Company Act of 1940 imposes very conservative leverage limitations on BDCs. The leverage limitations have not been revisited for the past 35 years since Congress initially adopted them as part of the original BDC enabling legislation. It is important that the leverage limitation be modernized to allow for BDCs to construct the appropriate balance sheet that is in the best interest of their shareholders. The legislation reported last Congress by this Committee to increase the amount of debt a BDC can assume would help the industry better balance the percentage of equity and debt while remaining conservative. Appropriate concerns have been raised about how to make certain that shareholders who have invested in a BDC that would not be able to assume more debt can be properly protected. We understand that the Committee has fine-tuned its approach to make certain that a BDC deciding to increase debt above the current law levels would provide appropriate disclosures to shareholders and engage in a transparent process that is consistent with the strong shareholder protections of the 40s Act.

Finally, BDCs should be permitted to issue preferred shares to institutional buyers. This change would provide yet another tool for BDCs to raise capital to redeploy to smaller and medium sized businesses.

These changes taken together underscore the importance of ensuring that BDCs have adequate access to capital so they can redeploy funds to support the small- and medium-sized companies that they serve.

IV. Conclusion

In conclusion, business development companies are an important source of capital for small- and medium-sized businesses. With some common sense reforms it is possible to increase the capacity of BDCs to offer capital to job-creating American businesses without in any way undermining the strong investor protections afforded by the Investment Company Act of 1940.

We applaud the efforts by the Committee and urge the Committee to act favorably on BDC reform legislation to expand capital access and remove inefficiencies in the current regulatory rules. Our industry and our economy, with its still unacceptably high unemployment rate, require action by the Committee in a manner that I have presented to you today without costing the government and taxpayers a single penny.

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June 15, 2015

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

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

Chairman Hensarling and Ranking Member Waters:

I am writing to express my strong support for the draft "Small Business Credit Availability Act", which are both being considered by the House Financial Services Committee as a means to modernize the regulation of Business Development Companies, or BDCs.

I am the CEO of OTG Management, an airport restaurant operator founded in 1996 in Philadelphia, Pennsylvania that is now proud to have operations in ten airports throughout North America with nearly $400 million in annual revenue and approximately 4,000 employees. Our Company's expansion required significant capital investment which was financed in large part by a Business Development Company and our success and continued growth could not have been fully achieved without the capital provided by BDCs.

As you know, most traditional banks have retrenched from providing financing to growing small and middle market companies like OTG Management. By statute, BDCs focus on investing in these companies and, accordingly, I believe it is important that Congress remove certain regulatory impediments on the ability of BDCs to support companies like ours.

I believe that the draft legislation will enable BDCs to more easily raise capital in the public markets which, in turn, will increase the number of loans that BDCs can make to "Main Street" companies. Please give this matter your fullest consideration and help Congress act on it in the near future.

Republican or Democrat, we all can agree that helping businesses grow and create more jobs is one of the most important things that Congress can do to help "Main Street" America. My own experience tells me that modernizing the regulation of BDCs in order to enable them to support businesses such as ours is an important part of this effort.

Sincerely,

Rick

Rick Blatstein

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