

**LEGISLATIVE PROPOSALS TO IMPROVE  
SMALL BUSINESSES' AND COMMUNITIES'  
ACCESS TO CAPITAL**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FIFTEENTH CONGRESS  
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**LEGISLATIVE PROPOSALS TO IMPROVE  
SMALL BUSINESSES' AND COMMUNITIES'  
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**Friday, November 3, 2017**

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENT,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 9:17 a.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Present: Representatives Huizenga, Hultgren, Stivers, Poliquin, Hill, Emmer, Mooney, MacArthur, Davidson, Budd, Hollingsworth, Hensarling, Maloney, Sherman, Lynch, Scott, Himes, Sinema, Vargas, and Gottheimer.

Also present: Representative Rothfus.

Chairman HUIZENGA. The committee will come to order. And without objection, the Chair is authorized to declare a recess of the committee at any time.

This hearing is entitled "Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital."

Just to get everybody on the same page here, they have moved up votes a little bit on us this morning. We have an anticipated voting time somewhere between 10:15 and 10:45. With agreement with the Ranking Member here, we are foregoing our opening statements, because it is about you actually. Hard to believe that Congress folks wouldn't want it to be about them. But it is about you, to hear from you all, and to make sure that we get to questions.

Just for the members, depending on our timing, the Chairman may exercise our prerogative to shorten your 5-minute question period. We want to get through as many folks as we possibly can in a timely fashion.

And with that, without objection, the gentleman from Pennsylvania, Mr. Rothfus, is permitted to participate in today's subcommittee hearing. Mr. Rothfus is a member of the Financial Services Committee, and we appreciate his interest in this important topic. And we are pleased that our final witness, was stuck in one of our famous lines here in getting into the office building, so we are glad you are here, Mr. Gerber.

So with that, today, we welcome the testimony of Mr. Patrick McCoy, the Director of Finance for the Metropolitan Transportation

Authority of New York, on behalf of the Government Finance Officers Association; Mr. Mercer Bullard, Butler Snow Lecturer and Professor of Law, University of Mississippi School of Law; Mr. Michael Gerber, Executive Vice President, Corporate Affairs of FS Investments; Mr. Paul Stevens, who is the Chief Executive Officer of the Investment Company Institute, ICI; and Mr. Tom Quaadman, Executive Vice President for the Center for Capital Market Competitiveness to the U.S. Chamber of Commerce.

Each of you will be recognized for 5 minutes to give your oral presentation and your testimony. And without objection, each of your written statements will also be made part of the permanent record.

With that, Mr. McCoy, you are recognized for 5 minutes.

#### **STATEMENT OF PATRICK J. MCCOY**

Mr. MCCOY. Thank you.

Chairman Huizenga, Ranking Member Maloney, and distinguished members of the committee, I am honored to be here today on behalf of the Government Finance Officers Association to share with you our comments on H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017, and its importance to public finance.

My name is Pat McCoy, and I serve as the President of the Government Finance Officers Association. But today, I will be speaking in that capacity and not in my other role as Director of Finance for the Metropolitan Transportation Authority in New York.

Founded in 1906, GFOA represents over 19,000 public finance officers from State and local governments, schools, and special districts throughout the United States. This includes about 2,500 Michigan and 1,500 New York national and State GFOA members. GFOA is dedicated to advancing fiscal strategies, policies, and practices for the public benefit, including topics related to issuing tax exempt bonds and investing public funds.

I am here to testify in support of H.R. 2319. Money market funds are an important means of financing capital requirements for State and local governments. But the SEC's (Securities and Exchange Commission's) change of net asset value, or NAV, accounting methodology from stable to floating has negatively impacted our ability to use them. H.R. 2319 would allow State and local governments to return to utilizing suitable investments as defined by State and local government officials rather than by the SEC.

GFOA has identified two key issues that should be weighed as Congress considers this legislation to improve access to capital. First, money market funds have been utilized effectively to both manage liquidity for public sector investments and to provide a reliable source of working capital to fund public services and finance infrastructure investment. Legislation such as this would allow governments to seamlessly continue accessing the capital markets without increasing costs for taxpayers. Money market funds are a widely used cash management tool for individuals, corporations, as well as for State and local governments.

According to Federal Reserve data, State and local governments hold over \$183 billion of assets in money market funds. Money market funds themselves are key purchasers of municipal securi-



ties. Historically, they have been the largest purchasers of short-term tax exempt debt.

GFOA has supported and will continue to support initiatives that both strengthen money market funds and ensure investors have access to high-quality securities that can be bought and sold in an efficient market. However, the SEC rule change that requires a floating rather than a fixed NAV created unintended consequences that impact large governmental entities and small communities alike.

Second, since the SEC rule changed from a fixed to a floating NAV, we have seen a negative impact on State and local governments. The original objective of the rule change was to protect investors in money market funds, but we think that those concerns were already addressed in the 2010 amendments to rule 2a-7. GFOA and other State and local government issuer groups supported those amendments. Despite the positive impact of the 2010 amendments, the SEC moved forward in adopting additional amendments to the rule in July 2014, which became effective just last year.

Throughout that process, GFOA and public finance officers throughout the country submitted analysis showing that a floating NAV would do little to deter heavy redemptions during a financial crisis and would instead impose substantial costs on State and local governments.

Between January 2016 and July 2017, tax exempt money market fund assets under management fell by half, from \$254 billion to \$135 billion, a dramatic shrinking of an important market for municipal debt. At the same time, municipalities issuing variable rate demand bonds saw their borrowing costs increase, nearly double the Federal Reserve's rate increases over the same period. Many State and local governments opted to issue higher fixed rate bonds because issuing variable rate debt to money market funds was costly. In both cases, the higher costs were shouldered by taxpayers and ratepayers.

Finally, the SEC rule changes implications for the investments State and local governments rely on to protect public funds. Many have specific State or local statutes or policies that require them to invest in financial products with a stable NAV. This ensures that public funds are appropriately safeguarded. Thus, State and local governments commonly use money market funds with a stable NAV for managing operating costs—operating cash. Requiring a floating NAV creates an unnecessary obstacle that has steered State and local entities into very low yielding U.S. Government backed funds or other alternatives from what was already a safe and highly liquid market.

Chairman Huizenga, Ranking Member Maloney, and distinguished members of the committee, public finance officers are encouraged by and support initiatives like H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017. I thank you for the opportunity to speak with you here today, and I will be happy to take your questions.

[The prepared statement of Mr. McCoy can be found on page 65 of the Appendix]

Chairman HUIZENGA. Thank you. We appreciate that.

And with that, Professor Bullard, you are recognized for 5 minutes.

#### **STATEMENT OF MERCER BULLARD**

Mr. BULLARD. Chairman Huizenga, Ranking Member Maloney, members of the subcommittee, thank you again for the opportunity to speak before you today.

I will focus my comments this morning on the BD leverage proposal. And I would like to think that we can all agree that before permitting BDCs (business development companies) to increase their leverage, we need to know how much leverage BDCs actually use, and ensure this information is fully and accurately disclosed.

It appears to me that neither condition is currently satisfied. We do not know how much leverage BDCs actually use. And if we do not know how much leverage they use, then it follows that BDC leverage is not being fully or accurately disclosed.

Over the last three decades, since the banking crisis of the 1980's, banking regulation has evolved to employ diverse measures of risk that provide a more accurate view of the threat of bank failure. Traditional diversification, concentration, and leverage limits have been supplemented by risk-based capital ratios, value at risk measures, liquidity coverage ratios, off balance sheet contingency weightings, tiered asset categories, stress tests, and living wills. These measures have still not kept pace with the development of increasing complex financial instruments and capital structures, but they have them within site.

The BDC leverage limit is a different story. It captures very little of the information one would need to evaluate a BDC's effective leverage. It does not consider the relative quality, priority, or term of BDC assets, nor does it capture the term reliability or portfolio income sensitivity of BDC loans. It does not reflect interest rate risk. Industry analysts agree the leverage limit is inadequate. One publication has stated, quote: "In our view, the raw leverage measure, debt over equity, doesn't tell the whole story as loans that BDCs hold have various degrees of implicit leverage," end quote.

This is a bit of an understatement as the effective ratio estimates by those same analysts bear little resemblance to the one-to-one statutory leverage limit. In the fall of 2015, for example, these analysts rated BDC leverage ratios as ranging from a low of .58 to 1 to a high of 7.57 to 1. The 7.57 ratio is obviously not consistent with the one-to-one statutory limit. The high of 7.57 to 1 is more than 13 times the low estimate, which shows a degree of variance that also does not comport with the statutory leverage eliminate.

These high-leverage ratios are not disclosed to investors, nor is their potentially disastrous effect. The BDC that had the 7.57 to-1 ratio showed in a recent filing that a mere 10 percent loss in the market value of its holdings would result in a 23.5 percent decline in the value of the shareholder stake. This disclosure is still inadequate. It posits that a 10 percent decline is a worst-case scenario. The SEC should know better.

In comparison, the Fed's worst-case scenario for its 2017 supervisory stress test assumes a 50 percent decline in equity values and a 25 percent decline in housing prices and a 35 percent decline in

commercial real estate and a 10 percent unemployment rate. I submit that worst-case scenario disclosure must reflect at least a 20 or a 25 percent drop, if not a 40 or 45 percent drop, in order to be useful.

It is fitting that the picture on the cover of this 2015 BDC scorecard is a photo of a man climbing a sheer rock face in running shoes without any ropes. I find that the inadequacies of BDC risk disclosure were matched by inadequate disclosure in other respects. A retail investor could not reasonably be expected to understand the mechanics of performance fees charged by BDC managers based on SEC mandated disclosure. I was unable to determine whether BDC managers that charge fees on top of fees charged by underlying funds or maybe a questionable practice were also double-dipping by being paid themselves by the underlying fund. Nor could I practicably determine whether and to what extent a BDC was actually investing consistent with its statutory mandate.

I am also concerned about BDC's enforcement history. A recent article by a former SEC examiner, John Walsh, lists a pattern of BDC enforcement actions over just the last 10 years that is extraordinary in the light of the fact that the total number of BDCs has never been much over 100. I recommend that members consider this article which appears in Volume 14 of the Dartmouth Law Journal before making a final decision on the pending legislation.

I again thank the subcommittee for the opportunity to appear before you today, and I would be happy to try to answer any questions you might have on this or other matters before the subcommittee. Thank you.

[The prepared statement of Mr. Bullard can be found on page 34 of the Appendix]

Chairman HUIZENGA. Thank you very much.

And with that, Mr. Gerber, you are recognized for 5 minutes.

#### **STATEMENT OF MICHAEL F. GERBER**

Mr. GERBER. Thank you.

Thank you, Chairman. Thank you, Ranking Member Maloney and the other members of the subcommittee, for the opportunity to participate in today's hearing. My name is Mike Gerber. I am an Executive Vice President at FS Investments, formerly named Franklin Square Capital Partners. We were founded in 2007 in Philadelphia with the mission of providing mainstream investors access to institutional quality alternative asset management.

We have used the BDC, among other structures, to execute on this mission. In 2009, we launched the industry's first ever non-traded BDC. We listed that on the New York Stock Exchange a few years later, in 2014, creating a liquidity event for our investors. Today, we manage five BDCs, and we have more BDC assets under management than any other manager in the industry.

We have investors from all 50 States. We have portfolio companies in 39 States. And across the industry, there are now more than 90 BDCs and more than \$90 billion in assets under management in the BDC space.

Importantly, no BDC failed during the Great Recession. We all know those were the worst economic times we have experienced as a country since the Depression. And I think it is a very important point to make because it is a very durable structure that has been protective of investors.

As you all know, in 1980, BDCs were created through bipartisan efforts with an eye toward matching mainstream investor dollars with Main Street businesses. Because BDCs were designed with an eye toward retail investors, they are appropriately very heavily regulated. In fact, whether traded or nontraded, BDCs are among the most highly regulated investment vehicles in the marketplace. And because of our extensive public filings, BDCs are fully transparent to regulators, rating agencies, analysts, lenders, and investors alike.

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 we must file 10-Ks, 10-Qs, 8-Ks, and proxy statements. Contained in every Q and K is a schedule of our investments, along with the details around those investments, such as the name of the portfolio company, the size of the investment, the position within the capital stack of that investment, interest rates, and current price marks.

Other key protections in the BDC include mandatory third-party custody of 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 evaluations of the investments in a BDC portfolio.

In addition, our nontraded BDCs are also regulated by FINRA and by the Blue Sky 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 is that BDCs must invest at least 70 percent of our assets in U.S. private and small cap companies. As a result, BDCs have provided a significant amount of capital to the middle market. Middle market businesses employ about 48 million people today, or one out of every three workers in the private sector. In fact, between 2011 and 2017, middle market firms generated 103.3 percent job growth compared to small business at 7.4 percent and large firms at 52.3 percent. And now, 42 percent of middle market firm companies say they expect to grow in 2018. So we believe it is important that middle market lenders like BDCs are well positioned to provide the capital necessary to fuel that growth.

There are two key aspects to this legislation, one that would streamline offering reforms making our offering of our securities more efficient for investors. Also, as the professor mentioned, would enable—there is a provision that would enable BDCs to increase leverage. We believe the increase in leverage is modest. First, BDCs—and important. First, BDCs would have more capital to deploy in the middle market, while keeping all investor protections that I mentioned in place.

Second, this would enable BDCs to build safer portfolios, delivering the same or higher returns, while investing higher up in the capital stack of portfolio companies.

Third, even with the proposed increase, two-to-one leverage would still be quite low when compared to other lenders in the marketplace. For example, banks are leveraged anywhere from 8 to 1 to 15 to 1. Hedge funds may even be over 20 to 1. And neither of those lending structures offer the same transparency as—

Chairman HUIZENGA. The gentlemen's time has expired.

Mr. GERBER. Yes, sir. Thank you, sir.

[The prepared statement of Mr. Gerber can be found on page 57 of the Appendix]

Chairman HUIZENGA. Thank you.

And we are going to need to move to Mr. Stevens. You are recognized for 5 minutes.

#### STATEMENT OF PAUL SCHOTT STEVENS

Mr. STEVENS. Chairman Huizenga, Ranking Member Maloney, and members of the subcommittee, I appreciate the opportunity to testify today on proposals to improve access to capital for small businesses and communities.

ICI is the leading association representing regulated funds globally, and our member funds are the vehicles through which more than 100 million Americans pursue important financial goals, including saving for retirement, college, or a first home. Registered funds also play a vital role in the U.S. economy. They channel capital from fund investors to the markets and users of capital. Funds help fuel innovation, growth, and job creation.

One measure that could enhance this process is Mr. Hollingsworth's bill, the Expanding Investment Opportunities Act. ICI fully supports the discussion draft, because we feel its provisions to modernize offering rules for closed-end funds will provide significant benefits to these funds, to their shareholders, and to the enterprises that they can help finance.

Like other registered funds, closed-end funds are comprehensively regulated under the Federal securities laws and Securities and Exchange Commission regulations. They differ from mutual funds, also known as open-end funds, because closed-end funds have flexibility to invest in a broader array of assets, such as stocks and bonds issued by small private companies.

For investors, closed-end funds provide enhanced income and cash-flow, increased after-tax efficiency, and broader diversification. We estimate that more than 3 million American households held \$271 billion in assets in 533 closed-end funds as of June of this year.

Now, despite their numerous benefits, the number of closed-end funds has declined sharply, by more than 19 percent over the past decade. In 2016, only 8 new closed-end funds issued shares, and that is a decline of 81 percent from 2007. Clearly, this well-established, well-regulated investment vehicle has untapped potential to help fund our economy.

Mr. Hollingsworth's bill would help reverse these trends. It would reduce the burdens of certain SEC registration and commu-

nications requirements that impose heavy costs on funds and their investors without commensurate investor protection benefits. The resulting cost savings would be passed on to fund shareholders, making these funds more attractive.

Now, while the discussion draft provisions are quite technical, they actually follow well-established rules governing securities issued by operating companies. If closed-end funds could avail themselves of these rules, they would be subject to all of the same conditions as operating companies, plus the extensive investor protections of the Investment Company Act.

When former SEC Chair Mary Jo White evaluated nearly identical legislative provisions in 2013, in that case with respect to BDCs, she concluded that, quote, "In my view, these provisions do not raise significant investor protection concerns." We agree, and we believe that now is the time for Congress to act.

Some will argue that these changes should be left to the SEC. In fact, the Commission suggested the need to modernize registration and communications requirements for closed-end funds in 2005. Unfortunately, it has not followed through, and the Commission has no fewer competing priorities today than it has had throughout the past dozen years. We believe that the discussion draft approach, giving the SEC 1 year to enact new regulations before the bill's provisions would take effect, is necessary and appropriate.

We have also heard concerns that automatic shelf registration would allow closed-end funds, including some funds that are not traded on exchanges, to register new offerings without a full SEC review. This is true, but similar treatment for operating companies appears to have worked quite well for more than a decade. Moreover, closed-end funds that utilize these provisions already will have filed a registration statement, reviewed and declared effective by the SEC staff.

For all these reasons, we wholeheartedly support Mr. Hollingsworth's discussion draft as a valuable set of reforms that will enhance financing for the economy, while maintaining stringent investor protections.

Mr. Chairman, if I may briefly comment on one other measure. ICI also supports the proposed offering and communications reforms for business development companies. We do not object to the bill's provisions to grant BDCs more flexibility to use leverage.

Mr. Chairman, Mrs. Maloney, members of the committee, thank you again for the opportunity to testify. I will be happy to take any questions.

[The prepared statement of Mr. Stevens can be found on page 79 of the Appendix]

Chairman HUIZENGA. Thank you, Mr. Stevens.

Mr. Quaadman, you are recognized for 5 minutes.

#### **STATEMENT OF THOMAS QUAADMAN**

Mr. QUAADMAN. Thank you, Chairman Huizenga, Ranking Member Maloney, members of the committee. Thank you for holding this hearing today. We appreciate the continued bipartisan leader-

ship of this subcommittee on issues related to capital formation and job creation.

Indeed, the passage of the JOBS Act and the recent introduction of reg S-K reforms by the SEC would not have happened without the efforts of this subcommittee. And the passage this week of bills by the House on testing the waters and accredited investor reforms show the continued dedication of this subcommittee on those issues. However, the situations of capital formation are still in dire straits, and much needs to be done to reverse the trends. To sum it up, the diminution of financial resources is calcifying entrepreneurship.

During this past recession and for the first part of the recovery, for the first time ever, business destruction outpaced business creation. This occurred for a contracted period of time, and business creation rates have not come back to prerecession norms. Bank lending to small business is down and small business capital needs are not being met. Firms that are less than 5 years old are being particularly hard hit, as are business loans of under a million dollars. This data comes from the FDIC Community Reinvestment Act reports, the Federal Reserve, and the U.S. Census Bureau. Our 2016 corporate treasurer survey and 2017 small business survey back this government data up. But the situation is even worse.

A 2016 study by the Economic Innovation Group found that between 2010 and 2014, 3 of 5 counties in the United States had more business exit than entries. And to make it even worse, 50 percent of all business startups occurred in 20 counties in only 7 States, representing 17 percent of the American population.

If we are to return to historic rates of economic growth and job creation, we need to fix these problems in a comprehensive and lasting way. The Chamber in a few weeks is going to issue an IPO report, and we look forward to working with this subcommittee on some of the comprehensive proposals we are going to make.

But the bills before us today are a step in the right direction. The Small Business Credit Availability Act drafted by Mr. Stivers deals with business development corporations. BDCs have slowly been filling the void, since the recession, of financial firms that have left for regulatory reasons, both to middle market and small market capital areas. And BDCs need to be doing more.

This bill would allow for a modest increase in leverage and would allow BDCs to deploy capital more efficiently. The SEC would continue to have oversight and regulations, and this bill would also allow for increased investor protections so that if there is an increase in leverage, investors have an opportunity, over a course of a year, to remove themselves from the BDC.

The Expanding Investment Opportunities Act by Mr. Hollingsworth deals with expanding the well-known seasoned issuer status to closed-end funds. This will disseminate information more quickly, end duplication, reduce costs, and have capital be deployed—deployed more quickly. If we allow high school students to use a common app to apply for a college, we should do no less for America's job creators. The quick passage of these bills will help middle market and small businesses meet their capital needs.

I also want to address a bill introduced by Mr. Rothfus, the Consumer Financial Choice and Capital Markets Protection Act. This

bill shines a light on a capital formation problem that must be reviewed. The money market fund reforms implemented by the SEC have made corporate cash management more difficult and inefficient and has reduced the pool of productive working capital. A recent study by the Treasury Strategies, which we would like to submit for the record, shows that there is a \$371 billion shortfall in business capital. More troubling, this has led to a crowding-out situation so that where big businesses are removing themselves from commercial paper and going into the bank lending space to meet their short-term needs, they are crowding out middle market companies and small businesses.

In conclusion, we believe that we can work together to solve these issues and put America back to work. We look forward to working with the subcommittee to find comprehensive solutions to these problems and addressing America's capital formation crisis.

Thank you, and I am happy to take whatever questions you may have.

[The prepared statement of Mr. Quaadman can be found on page 69 of the Appendix]

Chairman HUIZENGA. Thank you, Mr. Quaadman. I appreciate this.

I am going to attempt to hold the standard and not use my full 5 minutes, but I will recognize myself for 5 minutes.

The SEC's final rule provided money market funds with 2 years to comply with these new requirements, which ultimately became effective October 14 of 2016, the final rule also permits government and retail MMFs to use the method to seek and maintain a fixed NAV. Some market participants have expressed the concern that the SEC's 2014 rule would result in the loss of short-term liquidity in the capital markets, particularly in the municipal securities market.

Along with Ranking Member Maloney, we wrote to the Securities and Exchange Commission to review, and asked them to review the current landscape for MMFs (money market funds) and the impact of the 2014 rule on both short-term corporate and municipal financing. And without objection, I would like to enter into the record our letter to Chairman Clayton as well as his response letter.

Mr. Quaadman, Mr. Stevens, how, really very quickly, has the industry changed, or have we seen significant shifts in the money market since the October 2016 implementation date? And then I am also curious how the industry has adapted to the new rules.

Mr. QUAADMAN. We have seen—I will turn it over to Mr. Stevens in a second. We have seen a dramatic shift into government prime funds, and this is why you have also seen a dramatic retrenchment of businesses from using money market funds as a means of cash management. So it has actually changed the way that a corporate treasurer has to go out and manage their day-to-day activities in a negative way.

What I would also say too, if you look at this rule in conjunction with the Volcker rule, Basel III, and a number of others, what it does is it places a premium on government funds or shifting money into U.S. treasuries, which is also a concentration of risk, which I think the regulators have ignored and really should look at as well.

Chairman HUIZENGA. OK. Mr. Stevens.



Mr. STEVENS. I think that is a good summary. But what I would say is many of these effects were ones that were predicted at the time that these rules were in development. The ICI said many, many times that the proposals would have exactly the kinds of adverse effects that my colleague here has said in connection with municipal finance. And the way the rules are structured, prime assets have declined very precipitously and in their place rising just about as much have been government securities.

Chairman HUIZENGA. OK. Mr. McCoy, how are municipalities currently meeting their short-term financing needs? And how has the 2014 reforms impacted how municipalities handle their cash management needs?

Mr. MCCOY. Sure. Thank you.

I think in terms of short-term products available, there is really only one other meaningful product that municipalities use. It is an index-based note. So, for example, we take the SIFMA index or a percent of LIBOR and put a spread on that. And that can go out for 2, 3, 4, 5 years, whatever. That is really the only good alternative other than issuing short-term notes, which are not what I would characterize as a long-term financing vehicle. So I think from the issuance perspective, we have seen a dramatic reduction of State and local governmental issuers accessing this market.

And then from an investment perspective, as I noted in my testimony, treasurers across the country that invest public funds typically are held to a fixed NAV construct for those investments. And with this rule, we have seen them leave this market.

Chairman HUIZENGA. Chairman Clayton, in his letter, says that, basically, we should just take some more time and collect some data. I mean, do you have an opinion on this?

Mr. MCCOY. I think we are always looking at the data and what the data tells us. You know, we can't argue—

Chairman HUIZENGA. It is more of a time element here, right?

Mr. MCCOY. Certainly time, yes. We have seen assets in this complex drop by half, anticipating the rule change and then after the rule change. So I would argue that we have had enough time, and we have seen the impacts of the rule change. I don't think they are necessary.

Chairman HUIZENGA. OK. With that, I will yield back.

The Ranking Member is recognized for up to 5 minutes.

Mrs. MALONEY. Thank you so much. And I want to welcome all of the panelists here, particularly Mr. McCoy from the great State of New York and the MTA, and thank him for his work on completing the Second Avenue Subway, the best subway in the Nation, which happens to be in my district. Thank you so much.

I would like to continue on the Chairman's questioning and ask you about H.R. 2319. SEC Chairman Clayton, in his response to myself and Chairman Huizenga, stated that even if we repealed the NAV requirement from municipal and corporate funds, some investors might not come back to these funds. He stated, and I quote: "While some investors might choose to leave government money market funds and return to prime and municipal funds, such a shift also might not occur if investors newly appreciate prime and municipal money market funds' inherent liquidity and

principal stability risk and, therefore, choose to remain in government money market funds.”

So what do you think of his comments? Do you think that investors who have left municipal funds would come back if the floating NAV requirement was repealed?

Mr. MCCOY. I do believe that that is the case. I believe that investors would take more comfort in this product if they knew that a dollar was worth a dollar at all times. And, quite frankly, I think that is what we believe to be a core reason why investors fled this particular product in substantial ways that they did.

Mrs. MALONEY. OK. Then, Mr. Stevens, the Expanding Investment Opportunities Act is intended to modernize the offering rule for closed-end funds so that these funds are treated the same as normal operating companies like Google and GE. Of course, we know the SEC could make these changes on their own and decided not to extend the fast-track offering rules to closed-end funds back in 2005.

So my question is why did the SEC not include closed-end funds in the 2005 offering reform rule? Was it just an oversight or are there differences between closed-end funds and operating companies that make it difficult to apply the fast-track offering rules to closed-end funds?

Mr. STEVENS. Thank you for your question, Mrs. Maloney. I don't think it is the second of those. I think it is a fairly straightforward proposition. The SEC at the time said, oh, we will get back to that. I am speculating now. But sometimes it is very difficult when you have two different divisions at the SEC with responsibility that overlaps. In the case of operating companies, that is the Division of Corporation Finance. In the case of the closed-end funds, it would be the Division of Investment Management to come together and converge on a set of changes that will affect regulated entities in both spaces.

What we do know is that they said they would get back to it. And 12 years later, they haven't. And, unfortunately, I don't think there is any prospect that they will. I am very sympathetic to the limited regulatory rulemaking resources that they have and the many, many competing priorities. So with all the goodwill in the world, I just don't think, after a dozen years, we should think that they will return to the issue, absent some prompting.

Mrs. MALONEY. Thank you.

And, Mr. Gerber, as you know, the Small Business Credit Availability Act would allow BDCs to double their leverage. This could, in theory, allow BDCs to lend more to small- and medium-sized businesses or it could allow BDCs to simply increase their risks.

So my question is what would you use the additional leverage for? Would you lend to riskier companies or would you lend more to creditworthy small businesses? What would the impact be?

Mr. GERBER. Well, I certainly can answer for FS Investments, and it would be the latter. It would enable us to invest in more companies higher in the capital stack reducing risk, but still maintaining the returns that our investors have come to expect from BDCs. And I think it is fair to assume that the rest of the industry would follow suit. And I say that because capital availability to poorer performing BDCs will not be the same as it would be for

higher performing BDCs. In other words, those poor performers would not be able to do 501 offerings, issuing new equity. They would not be able to draw down more debt from lenders, from the banks. So I think it is fair to assume that that would be an industry-wide approach. Investing higher in the capital stack, taking on less risk.

Mrs. MALONEY. Well, I am sympathetic to the testimony of Mr. Quaadman where he said this would move more credit availability and investment to smaller-sized companies that often do not get the attention they deserve.

Thank you very much. My time is up.

Chairman HUIZENGA. The gentlelady's time has expired.

With that, the Chair recognizes the Vice Chairman, Mr. Hultgren, from Illinois for 5 minutes.

Mr. HULTGREN. Thank you, Chairman. Thank you all for being here.

Mr. Stevens, if I could address my first couple questions to you regarding the Expanding Investment Opportunities Act, the draft legislation that is being sponsored by Mr. Hollingsworth. From what I understand, this is a fairly simple piece of legislation that should have strong positive impact for investors and for our capital markets.

Three questions here, if I could. In general, why do you believe the number of closed-end funds has declined in recent years? And then how will expanding investment opportunities in closed-end funds benefit investors? And then final part of that, can you speak to the significance of closed-end funds flexibility to invest in less liquid securities? I know on page 2 of your testimony you talk about this. And what are some of the examples that come to mind and how will this contribute to capital formation? A lot there.

Mr. STEVENS. I hope I remember all three of those questions.

Mr. HULTGREN. First one, why closed-end funds have declined in recent years.

Mr. STEVENS. They compete in the ecosystem of financing with lots and lots of other alternatives, and including some innovations, like exchange-traded funds, which are extraordinarily popular now. They exceed \$3 trillion in assets, in ETFs (exchange-traded funds), in the United States. There is a straightforward quality about ETFs. Closed-end funds are a slightly more complex vehicle. But I think the bill that Mr. Hollingsworth has in view, at the margin at least, provides a modernization for closed-end funds with respect to the way they can respond to market developments, bring their new issuances to market, inform their investors, and will make them at least marginally more competitive.

Now, why is that important? I think it is important because they occupy, again, a unique space within the framework of regulated investment companies. They have opportunities to invest in small enterprises, in stocks and bonds that would not necessarily be ones that an open-end or a mutual fund company would. They have opportunities to leverage their portfolios in ways that mutual funds would not, and enhance the yield that they offer to investors. And they have opportunities to provide additional tax efficiencies.

So in the broad array of investment opportunities, they occupy a specific place, and I think it is a good one. They have been part

of our industry since 1940. And I think these modest reforms that are in view here will continue to make them an attractive option for investors without sacrificing any protections.

Mr. HULTGREN. Thank you.

I want to move on to the money market fund legislation. And first, Mr. Chairman, I would like to enter a letter into the record dated December 1, 2016, which is addressed to Speaker Ryan from the State Finance Officers Association, requesting consideration of the Consumer Financial Choice and Capital Markets Protection Act, one of the three bills we are reviewing today.

Chairman HUIZENGA. Without objection.

Mr. HULTGREN. Next, Mr. McCoy, if I can address this to you. I was wondering if you could speak to the merits of this legislation. What have the SEC's money market fund rules meant for your cost of financing?

Mr. MCCOY. Thank you for that question, Congressman. As a large issuer, we need access to all parts of the yield curve to finance long-term infrastructure. And what we have observed over many years of issuing bonds and notes and products into the money market complex is that our lowest cost of funding has always been achieved using variable rate products at the short end of the yield curve, which go right into the money market complex.

Mr. HULTGREN. Thank you.

Mr. STEVENS, going back to you. Does the SEC have the legal authority to amend these money market fund rules? And should Congress let the SEC review the data and decide how to move forward with this rule?

Mr. STEVENS. It would have the authority, Congressman. You know, I have spent many more than 5 years of my life since 2007 on money market fund issues, through two sets of really extensive reforms of money market funds. I don't think, at least from the perspective of our membership, that there is a lot of conviction around going through yet another extended process at the SEC. And I am absolutely convinced that at the SEC they have other priorities that they would like to be addressing.

Mr. HULTGREN. Thank you.

I will yield back a few extra seconds here as well. So thanks, Chairman.

Chairman HUIZENGA. Much appreciated by everybody.

So with that, the Chair recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Yes. Thank you, Mr. Chairman.

Mr. Gerber, let me start with you. But first let me, as one University of Pennsylvania graduate to another, welcome you to the Financial Services.

MR. GERBER. Thank you, Congressman.

Mr. SCOTT. Get back to Philadelphia, give my regards to the Wharton School of Finance.

Mr. GERBER. We will.

Mr. SCOTT. Let me ask you, I have worked on this bill with my good Republican friend Mick Mulvaney when he was here, he is now the budget director, that will help the small business development corporations that your bill will. And I understand that you, from my staff, that you and Mr. Stivers have made some changes

to the bill, improvements to the bill, that address some of the concerns of the consumer advocates. Would you take a moment and share those with us?

Mr. GERBER. Sure. Sure. Thank you, Congressman.

You are right, when the bill was introduced in the previous Congress, and we had a hearing similar to this one a couple of years ago on that bill, there were five key provisions in that bill. And three of those five provisions are no longer in the bill—or are not reflected in the current discussion draft that Congressman Stivers has authored.

One of those three that is no longer in there was the subject of an amendment addressed by Congressman Himes. And that provision would have expanded the definition of eligible portfolio companies. So as you know, we have to invest 70 percent of our assets in private or small cap U.S. companies. And in that 30 percent bucket, we can invest in non-U.S., large cap, mid cap, and financial companies. And I think there was bipartisan concern over expanding the definition, particularly with the focus on not wanting BDCs to invest more in financial companies. That provision is no longer in the legislation. That has come out. And that was one that caused concern by consumer groups, investor protection groups, as well as both Republican and Democratic Members here in the House and in the Senate.

Mr. SCOTT. Very good.

Let me go to you for a moment, Mr. McCoy, on another bill that I have worked on prior to that, and that is Congressman Rothfus' bill, which is the Consumer Financial Choice and Capital Markets Protection Act, along with my Democratic colleague, Ms. Moore. And I wanted to make sure that you would share with the committee some of the issues. There has been an incredible disruption that I have seen in the marketplace for money market funds, specifically for the tax-exempt funds. And would you comment on that in particular and see how this legislation improves that?

Mr. MCCOY. Sure. Thank you. You know, as I noted in my testimony, the significant retreat from this product by retail investors who have typically invested in money market funds, tax-exempt money market funds, has had an effect to cause State and local governmental issuers who have historically been very active in that market to retrench and, as I noted, to go into other products, most predominantly fixed rate bonds which, of course, carry a higher cost of interest than a money market product than a variable rate demand bond. So that has had an effect on our ability to access, again, what we believe to be is the most efficient part of the yield curve, again, for building infrastructure.

Mr. SCOTT. OK. Well, thank you very much.

And, Mr. Chairman, may I make just a brief inquiry to you? And I want to ask if you would be kind enough, you and Chairman Hensarling, to—would it be possible for us to move these bills? They are both bipartisan bills. And I know we are getting to crunch time at the end of the year. Do you think, working with Chairman Hensarling and you, that we could get these bills on the floor for a vote and over to the Senate before Christmas?

Chairman HUIZENGA. The gentleman's time has expired. No. We will certainly be giving this full consideration. As you can see, we

have the hearing today for the purposes of gathering that information and working toward that. The fact that there is broad bipartisan support helps any and all issues coming out of this committee, and certainly helps over on the other side of the Capitol as well.

Mr. SCOTT. Yes, sir. Thank you, Mr. Chairman. I appreciate it.

Chairman HUIZENGA. Now the gentleman's time has expired.

All right. With that, the Chair recognizes the gentleman from Arkansas, Mr. Hill, for 5 minutes.

Mr. HILL. Mr. Chairman, I wanted to talk to Mr. Stevens a little bit more about the closed-end funds issue. Thank you for the discussion you had with my colleague about their competitive position and compared to ETFs. And one of the strong, I think, issues is that they can pursue strategies that involve some leverage and disclose that.

Would you say that that is really one of the principal advantages in this ecosystem you are talking about? I mean, from an investor point of view, the transparency of the data, and reflect a little bit more on that, both on fixed income and equities.

Mr. STEVENS. Well, the current closed-end fund business is about maybe 60 percent fixed income investment and about 40 percent equity. And, yes, I think, Congressman, their ability to use a bit of leverage in their portfolio is something that is characteristic of closed-end funds and provides them an opportunity to enhance their return to their investors. And that, I think, in part, is what makes them attractive; in a sense, that gives them advantages in terms of tax management and things of that nature. So, again, it is a unique characteristic that they have. And we are talking about a range of different investment options.

But as I said in my testimony, I think there is untapped potential there. I don't know how large it is, but untapped to be a source of financing to small enterprises and for other purposes in the economy. And that is a good thing, in my view.

Mr. HILL. And do you think they have an advantage over attracting, as you say, smaller market cap stocks into that—as a collective format rather than some of their competitors?

Mr. STEVENS. Well, if you think about mutual funds and ETFs, the nature of their investments, ETFs are largely index products, so they are looking at, in many instances, large cap issuers and the like. Mutual funds tend to be larger in terms of their size. And so just their ability to invest in much smaller businesses, the stocks and bonds, is going to be constrained in a way that, with a smaller closed-end fund, would not necessarily be the case.

Mr. HILL. Yes. Because I think that has, over of the years, really become a real challenge both in—we have talked in this committee many times about the cost of being public. But even if you move that down from very, very high market cap levels to smaller, you still have the coverage issues and the institutional investor interest area, even if it is a worthy company. And so we don't have many collective places for people to experiment with different market cap sizes.

And, again, I agree with you on indexing that it, for the most part, drives the larger more liquid names, as it should be, by definition of being an index or a near index-type process.

Do you know of a closed-end fund trend where they really do seek out smaller market cap names? Have you seen that among some of your members that have really been a source of looking for that emerging company that doesn't fit with a Morningstar style box that doesn't have the market cap required by a larger ETF requirement?

Mr. STEVENS. I think those are exactly the investment opportunities that many of them are seeking out.

Mr. HILL. So you would say that that business is changing before our eyes, and you think that these proposals today would make that a more compelling and easier for them to pursue that strategy?

Mr. STEVENS. It is going to make them be able to get to market more quickly with respect to new issuance. It is going to facilitate their communications with the investing public. Now, I don't think this is going to be some revolution overnight. But at the margins, it is modernizing the ways in which they engage in a marketplace.

Mr. HILL. But I just think this is a really interesting capital formation question.

Mr. STEVENS. I agree.

Mr. HILL. Because you can't say that a closed-end strategy per se can compete with large cap growth international per se, although we have closed-end funds that do that. And so this to me is an opportunity maybe for the industry to transform itself and change and adapt, while so many of what we would think is a traditional collective investment have moved to lower cost different formats.

Mr. STEVENS. And that is why we support the changes.

Mr. HILL. Yes. I appreciate the time.

I yield back, Mr. Chairman.

Chairman HUIZENGA. We are on a roll. The gentleman yields back.

With that, the Chair recognizes the gentleman from California, Mr. Sherman, up to 5 minutes.

Mr. SHERMAN. I want to add my voice to Mr. Scott's, that I hope we move forward on a markup. I would like to thank the Chair for holding these hearings and hope that it actually leads to a markup, as the gentleman said, well before Christmas.

I want to first talk about small business development companies, because if you look at the capital structure of the United States, we have a lot of systems that move money to large corporations, to government bonds, to real estate. And yet the national interest, I think, requires that we are able to have vehicles that move money to small businesses, and that is where the technological changes that will give us high GDP growth are going to come from.

I would point out that the discussion draft, Small Business Credit Availability Act, is patterned after a bill that passed through this committee 53 to 4. And it is my understanding that it is now a skinnier bill which incorporates, I believe, Mr. Himes' amendment. So you have a chance to start with a 54 to 3, depending upon what Mr. Himes says later. I am not speaking for him. That is a pretty good starting point.

Mr. Gerber, in his testimony, Professor Bullard states that markets and regulators lack adequate method for estimating BDC le-

verage and its effect. The professor sites one industry measure that suggests that effective BDC leverage is actually several multiples of the current one-to-one limit. Can you tell us more your understanding of this concept of effective leverage?

It seems like we are using a ruler with inches on it to measure the leverage of banks and other institutions in our society. And the professor is suggesting that we use millimeters to measure the leverage of BDCs. I am all for the metric system, but then we would, in order to put things in context, also have to use millimeters for measuring the leverage of all the other financial entities.

So tell me what you—explain this effective leverage, as you understand it, and how it would allow—how your leverage compares, whether we are using millimeters or inches, to leverage off other financial institutions.

Mr. GERBER. Thank you, Congressman. As I stated in my testimony and in one of my answers to an earlier question, BDCs are required, under the law, to provide a very significant amount of transparency into our portfolios; far more transparency than the banks are required to provide with respect to their lending practices or the portfolio companies to which they lend money; far more than other capital providers in the capital markets like hedge funds. So we are already starting off with a very transparent model.

One of the disclosures that is required of BDCs is that of how much leverage is being used by the BDC. Financial leverage. I mean, how much money has been borrowed by the BDC so that the BDC manager can deploy that borrowed capital alongside the equity capital. That is fully transparent. That is financial leverage.

I think the effective leverage, and I am using air quotes on that, the effective leverage factor or formula is one that was designed by an analyst. And I think it speaks to the transparency of the BDC model. That analyst was able to take the information that is provided in our disclosures every quarter to come up with this formula. And I think if you were to talk to that analyst, and I can't speak for him, but I think if you were to talk to that analyst what he would tell you is his formula is not measuring the financial leverage in a BDC. It is trying to put a score on the portfolio construction of the BDC by looking at where in the capital stack the BDC is deploying its assets. And so the lower in the capital stack any one investment is, the higher the score would be. And then he makes a bunch of assumptions.

So he just puts a number on mezzanine debt. He puts a number on CLO debt. He puts a number on equity. But he doesn't actually look at the underlying portfolio company to determine how much debt is on that underlying portfolio company to come up with this score. So it is a shorthand way to enable BDC investors to compare BDCs. It is not a measurement of financial leverage. And I think that is a very important distinction. I would also add—

Chairman HUIZENGA. The gentleman's time has expired. I'm sorry. We have got to get to other questions.

Mr. GERBER. Yes.

Chairman HUIZENGA. The gentleman from Maine, Mr. Poliquin, is recognized for 5 minutes.



Mr. POLIQUIN. Thank you, Mr. Chairman. I appreciate it. Thank you all very much for being here, gentlemen.

I represent rural Maine, and I am very concerned about small businesses. We don't have very many large businesses in the State of Maine. We have got a lot of mom-and-pops and a lot of mid-sized companies, small companies. And access to capital is absolutely critical. This is always something that is on my mind. Second of all is we have a lot of small savers, a lot of small investors who are looking to save for their kid's college or technical education or their own retirement. So cost and transparency is also very important when you are looking at various investment vehicles.

Mr. Gerber, if I could ask you a question, and just give you a—just a couple—just a bit of information here, and you probably already know this, is that the State of Maine has benefited from BDC investment to the tune of about \$76 million, including investments in Auto Europe, CashStar, Fiber Materials, Native Maine operations, tools and technology and what have you. So we are very grateful for the structure, the investment vehicle that you folks represent, you represent here on this panel today.

One of my questions is what about valuing the underlying portfolios? Tell me how this works. If you are a publicly traded BDC, do you have to mark to market any specific time? And what if you are not publicly traded? And what if I am an investor? I am worried about the little guy, the little investor, and I want to participate in a vehicle that you offer, how often do you folks mark to market as required by law, and should that change?

Mr. GERBER. Yes, sir. So whether a BDC is nontraded or traded, it is required under the law every quarter to post the schedule of all investments in the portfolio. The law also requires a BDC to mark at least 25 percent of that portfolio every quarter, so 100 percent on the year. Now, at FS, we happen to do 100 percent of the portfolio every quarter.

Mr. POLIQUIN. So if I am an investor and a small investor, I am trying to get access to the information that you are providing such that I can determine if your investment vehicle is right for me, then the best I can do is—especially for a BDC that is not traded, is every quarter get a valuation of my investment?

Mr. GERBER. That is right. And I think it is important to note that those valuations are handled by third-party valuation firms, and then have to be approved by a majority of the independent directors on the board of the BDC. So not only do you have the transparency, but you have a couple of layers of independent protections.

Mr. POLIQUIN. Where does an investment in a BDC fit for a middle class family in Maine or any other place around the country? And how would that compare to someone investing in a venture capital fund, for example?

Mr. GERBER. Sure. So the investment strategies used by BDC managers are quite different than venture capital strategies. Venture capital, you are usually taking a position—an equity position in a startup company.

Mr. POLIQUIN. Qualified investors.

Mr. GERBER. Qualified investors or credit investors in some case, but usually qualified investors. And usually, that venture capital firm strategy is to make a bunch of bets knowing that most of them

will fail and hoping that a couple of them will really hit it. And so it is a much riskier venture.

With BDCs, we are investing primarily in senior secured debt of established companies. So you don't have the risk of a startup and you don't have the risk of taking an equity position. Now, that is not to say that BDC portfolios won't at times have exposure to equity and have a percentage of the portfolio in equity investments. But most BDCs are predominantly investing in senior secured loans or debt of a private company.

Going back to the beginning of the question about the investor, why would an investor consider a BDC? It is an opportunity to diversify a portfolio. So the way we manage assets and the types of investments we make tend to be less correlated with the markets than a publicly traded stock or a publicly traded bond, because we are investing in private companies.

Mr. POLIQUIN. Thank you, Mr. Gerber. Thank you very much.

Mr. Stevens, if you could comment a little bit on the fit of a closed-in fund when it comes to a working class family in our society that is looking to save for the future for their nest egg or they are putting the kids through school or what have you. Where would a closed-end fund fit, in your opinion, as compared to a BDC?

Mr. STEVENS. Well, we have an investor base of 3 million households.

Mr. POLIQUIN. Right.

Mr. STEVENS. Our understanding is that closed-end fund shares are not uncommonly held, for example, in an individual retirement account. That may be a vehicle that can be held longer term for retirement purposes, again, as a way of diversifying your exposure to different kinds of assets. And we think that is commonplace among the investors in these vehicles.

Mr. POLIQUIN. Thank you, gentlemen, very much for being here. I appreciate it very much.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I want to thank the witnesses for helping the committee with its work this morning.

Mr. Chairman, I ask unanimous consent to submit a letter from the Office of the Mayor of the city of Quincy, Massachusetts, Tom Koch, a dear friend of mine, in support of the Consumer Financial Choice and Capital Markets Protection Act of 2017. That is H.R. 2319.

Chairman HUIZENGA. Without objection.

Mr. LYNCH. Thank you.

Tom Koch is a great pal of mine. We are not necessarily in harmony on our thoughts on this bill, but that is because every city is not run as well as Quincy, Massachusetts. Let me just put that out there.

And I want to turn to the other—the BDC bill there for a minute. I was one of the four Members who voted against the BDC last time. I think the bill has been enormously improved by Mr. Himes' amendment, the gentleman from Connecticut, but I am still not there yet.

Let me just ask Professor Bullard, in your testimony, you cite the fact that—at least in the earlier iteration of this bill, BDCs were allowed to invest, I think, 30 percent of the corpus of their funds in financial institutions. A lot of investment was going into financial institutions and structured products, collateral loan obligations and things like that, that weren't necessarily helping small- and medium-size operating businesses.

Look, if we were just talking about that, I would be with this bill, because I do believe that we need access to capital for those smaller- and medium-size businesses. My problem is that we have allowed this significant part of this bill to be directed toward, previously, financial institutions and structured products that allow, I think, an amplification of the leverage and risk that is involved here. And, also, it does not help. It does not help those small businesses and mid-size businesses that we are supposed to be assisting in this bill.

Is there a rebalancing? Is there a rebalancing that could be possible here, in addition to what Mr. Himes is doing—and I applaud his good work—to make sure that the lion's share, or almost the lion's share, of good here is really directed to those companies that need the help?

Mr. BULLARD. Well, I guess I would like to first say that in the last week of reading through registration statements, I have been very impressed by the number and diversity of investments in BDCs. I hadn't done that reading before, and with the weekend coming up, I recommend that highly to the members of the subcommittee.

Mr. LYNCH. Not likely, but thank you.

Mr. BULLARD. But the answer to your question is that it is hard to know exactly what the right percentage is for a leverage limit. But one direct response would be simply to require that additional leverage go 100 percent to the companies for which it is intended so to not allow doubling of leverage to be used to double the amount invested in that 30 percent window.

Also in my testimony, I have asked why, given that there may have been reasons in the 1980s you needed a 30 percent basket, why not reduce that and also directly provide for more assets to those economies? And then, third, in looking through the structure of these BDCs, many, if not most, have significant buffer between the limit they are allowed, meaning that they have made .5 to .6 ratios as opposed to a 1 to 1. And if a prudential rule of this nature is structured correctly, that should not be the case.

The way the rule like this should work and works in other context, insurance, banking, similarly in money market funds, is that you go up to the limit. There is a mechanism that if you are pushed across it by changing asset values, which Mr. Gerber mentioned in his testimony, then there should be a grace period. It should be that you can't take on additional debt, but that that shouldn't cause you, by something outside of your control, to be in violation of the limit. And I believe there should be a way in order to make adjustments. It may be the dividend requirement. It may be that banks are just not very flexible on renegotiating the one-to-one covenant, I guess.

Mr. LYNCH. Right.

Mr. BULLARD. But if this bill goes through, I think they are going to have to renegotiate the covenant anyway. So I think there is a way that would let them get the full benefit of the current one-to-one. And what that would do is, firms like Mr. Gerber's and I have looked at their structure, and the concern is not his type of BDC, it is the one that is at the far end of the spectrum and is going to make life a nightmare for his BDC if there is a severe liquidity event and it fails.

So I would look into that as a way of allowing BDCs to get the benefit of the leverage limit we intend, and I—

Chairman HUIZENGA. The gentleman's time has expired.

Mr. LYNCH. I am out of time. Thank you, Mr. Chairman. Thank you, Professor Bullard.

Chairman HUIZENGA. With that, the gentleman from Minnesota, Mr. Emmer, is recognized for 5 minutes.

Mr. EMMER. Thank you, Mr. Chair. I would like to request unanimous consent to enter into the record a letter from the Association of Minnesota Counties, which expresses their support for the Consumer Financial Choice and Capital Markets Protection Act. And I share their support for the legislation, and thank Mr. Rothfus for his work on the issue.

Chairman HUIZENGA. Without objection.

Mr. EMMER. Mr. Quaadman, in your written testimony, you mentioned that Congress should, quote, "look at creating the legal framework to allow for venture exchanges in an effort to improve secondary market trading for small public companies."

Can you just comment on some of the issues that you see these small public companies currently face in today's market structure and how you think venture exchanges could help?

Mr. QUAADMAN. Yes. Thank you for that question, Mr. Emmer. I think the two underlying issues that are at the heart of the capital formation problem here are: One, our liquidity; and two, is research and information. I think one of the things that the venture exchange could do is to help drive liquidity to those small cap companies. And I think if you look at it in conjunction with the bills that we are talking about here today, you would take a multifaceted approach to try and drive liquidity into those markets.

I think some of the WKSI issues that we are talking about as well are going to activate other participants. And I think that helps to get at the liquidity issue. I think we are going to have to do some other things in terms of trying to drive out research and information as well.

Mr. EMMER. Thank you very much. And because of our time and the votes pending, I am going to yield the balance of my time to my colleague from Ohio, Mr. Stivers.

Mr. STIVERS. I would like to thank the gentleman for yielding.

And I have a yes or no question for Professor Bullard. Professor Bullard, in preparation for this testimony, did you by any chance have a chance to talk to Jonathan Bock from Wells Fargo, who is the analyst who came up with the effective leverage ratio method that you quoted so extensively in your testimony?

Mr. BULLARD. No, I haven't, and I am not endorsing that leverage ratio.

Mr. STIVERS. Thank you. And I did have a chance to talk to him. And I got an email through Wells Fargo from him this morning at 7:21.

Mr. Chairman, without objection, I would like to enter it into the record.

Chairman HUIZENGA. Without objection.

Mr. STIVERS. Thank you.

So I would like to quote from the email that Mr. Bock sent me, the statement, and I will just quote some excerpts, but the whole statement will be entered into the record.

He said he wanted to offer some additional color on the effective leverage statistic in his BDC scorecard, because he is concerned many of the items are being taken grossly out of context. Those are his words. He says that, first, effective leverage should not be confused with financial leverage, which is what the bill changes. Effective leverage is a chance to look at BDCs' risk profile between each other based on their asset composition. Then he goes on to say: This isn't exact, and in no way is the gauge of financial leverage taken on by a BDC.

Then he goes on later to say: Also taking a step back, if folks would like to talk about imbedded leverage risks with BDCs and pass it off as financial leverage, then those same individuals might want to reexamine all bank and REIT balance sheets whose leverage would skyrocket.

And, in fact, Mr. Chairman, I would like to enter into the record an analysis of some banks using the effective leverage ratio, the lowest of which would be 49, the highest of which would be 93.

Chairman HUIZENGA. Without objection.

Mr. STIVERS. Thank you.

It then, Mr. Bock goes on to say: The major point missed is that investors, through this analysis and BDC transparency, have actual ability to understand the overall risk composition of each BDC. Banks don't offer that same kind of transparency. Then he says, last, folks arguing that effective leverage is too high, then in quotes, thus, this isn't a reason to look at the bill, missed the fact—and closed quotes. Missed the fact that increasing leverage—the leverage constraint will actually make effective leverage ratios fall, not rise. At the current leverage constraints, several BDC managers are actually reaching for risk owning low-quality subordinated securities, CLO, or sub-debt, to try to hit yield bogeys for investors.

So I will stop there on that and yield back the balance of my time. I look forward to my time later to talk more.

Chairman HUIZENGA. The gentleman from Minnesota?

Mr. EMMER. I yield back.

Chairman HUIZENGA. The gentleman from Minnesota yields back.

With that, the Chair recognizes the gentleman from Connecticut, Mr. Himes, for up to 5 minutes.

Mr. HIMES. Thank you, Mr. Chairman. And thank you to all of you for being with us.

And I would like to say a special thank you to Mr. Stivers. I was one of the lonely opposition votes to the Mulvaney bill in the last Congress, really exclusively because of the leverage that one might

imagine in that 30 percent bucket where investments in financial companies, in particular, are permitted. Not inconceivable that a financial company could have 10X, 15X leverage itself, you double that, you get into some pretty heady numbers. And I opposed it on that basis.

And I really thank Mr. Stivers for making the change, including the one I proposed in the amendment, which I offered and withdrew. So I guess my neighbor in Massachusetts is not quite there, but I am supportive of the bill in its revised form.

Professor, you, in your testimony, write something, though, that is interesting to me because of my concern about that leverage and the 30 percent bucket. In your written testimony, you say it is not clear that that 30 percent basket serves any purpose in modern financial markets. This of course, was established when BDCs were created initially.

What I would love to do with my remaining time, I am going to go to you and Mr. Gerber. I think that is an interesting question, and it certainly catalyzed my leverage concerns in the last Congress. So I wonder if I could give each of you a minute to reflect on the public good associated with that 30 percent basket. And, actually, Professor, let me, since Mr. Gerber is in the business, let me ask him to start, and then you can respond to what Mr. Gerber has—anyway, Mr. Gerber.

Mr. GERBER. Thank you, Congressman. I think as a threshold matter it is important to note that that 30 percent basket doesn't just cover financial companies; it covers large cap, mid cap U.S. companies, it covers non-U.S. private, small cap, mid cap, large cap companies, as well as financial companies.

How an individual BDC manager chooses to use that 30 percent bucket is a different issue, but I just think it is important to recognize that, in that basket, you could have a very diverse set of assets, not just financial companies. I think that is an important point, number one.

Number two, that basket is often used for the benefit of investors because there is an opportunity to use that basket to help generate yield. And part of our mission is to deliver strong returns to our investors. And so while very limited, because only in that 30 percent bucket there is an opportunity to use that effectively to generate returns for investors.

I would say, number three, that just because a company is a financial company doesn't mean it doesn't have value in the broader capital markets. We have financial company assets in our portfolios. We believe they are good companies. They are operating companies. They run lending businesses. They are lending to smaller businesses than we lend to, whether it is through equipment leasing programs, factoring programs, or just doing smaller deal sizes than we can do because of our scale. And those underlying portfolio companies play a very important role in the capital market.

So I would say there are benefits to investors and there are benefits for the capital markets in giving us the ability to deploy assets in that 30 percent bucket which, again, are not all necessarily financial companies.

Mr. HIMES. Great. Thank you.

Professor, let me give you my remaining 90 seconds to reflect on that.

Mr. BULLARD. I guess the short finance answer would be if investors want the additional yield from the 30 percent, they should get it from a vehicle that is designed to provide that. If BDCs want to compete effectively with each other, they should compete on the basis of their BDC investments, not depending on whether the BDC invests a lot or a little of the 30 percent in small- and mid-size companies.

So from an efficiency point of view, it is much more efficient, unless there is some reason that they needed this release valve, which is probably what in 1980 this was intended to provide. And given the liquidity of current markets and the ability of very, very large BDCs to find the investments they need, it seems to me highly unlikely that there would be any serious impediment to their ability to do that, and it would enhance their status, essentially, as what has become a unique asset to reduce that percentage.

Mr. HIMES. Great. Thank you. That was more to satisfy my own curiosity. So I appreciate the reflections, and yield back the balance of my time.

Chairman HUIZENGA. The gentleman yields back.

The Chair recognizes the gentleman from New Jersey, Mr. MacArthur, for 5 minutes.

Mr. MACARTHUR. Well, thank you, Mr. Chair.

Let me talk for one moment before I ask a question. Let me talk as a businessman, which I was for 30 years, instead of a Congressman, which I have only been for 3. I have lived in the world of depending on both BDCs and closed-end mutual funds. I bought my company with the help of a closed-end mutual fund that was trying to transform itself into an operating company. It would have been a lot easier had I been able to invest without what we had to go through. And at one point, the use of a BDC was really essential for me in growing the company. And that company, with one office and a hundred people, grew over 15 years to 6,000 people and 100 offices. You can't do that without capital. Can't do it.

And so I want to mention three things that I think are useful. One is just a reminder that business people rely on tranches of capital, both debt and equity capital, not one source. And so I think it is incumbent on us, with good public policy, to try to facilitate as many of those available tranches as possible.

Second, companies evolve. And what I needed in an early stage small company was quite different than what I needed as a mid-market company.

And, last, is there is simply no way for public policymakers and regulators to anticipate all of the things that business people can imagine. And so we should create the most flexibility, the most openness, and try to facilitate a good match-making environment where investors can make investments in all different kinds of opportunities, and business people can find all different kinds of credit—or capital, both through the credit markets and the equity market. So I support these reforms because I think they all tend toward that.

My question is on one that is a little different, and Mr. Quaadman, it is for you. You mentioned in your written testimony

that you supported an increase in Tier 2 reg A-plus offering limits. You supported something over the current \$50 million. And the Treasury Department recently published the report also recommending that we increase those limits. There was a provision of choice, which bumped it up to \$75 million. And I think that is going to be coming back as a standalone.

I just wanted to ask you how you thought that increase from \$50 million to \$75 million would help small businesses access capital and what the results might be, from your perspective?

Mr. QUADMAN. Thank you, Mr. MacArthur. And, also, I would also just add, in your preamble, I would also add in international operations as well also have a different capital structure that businesses would need.

In terms of bumping up the reg A-plus, we were very supportive of the JOBS Act provision. We thought this is a way to help make it easier for small business to access capital to get deals done. To do that, I know, even with the bump up to \$50 million, it has been—I think people are still finding their sea legs there. But, again, in terms of driving liquidity, we thought that the \$75 million number was important.

We did also participate with the Treasury Department on a specific roundtable on capital formation in the runup to that report. And this was a matter of discussion that we had as well. So this is an important way to help inject more liquidity and deal-making for small businesses to acquire the capital that they need to grow.

Mr. MACARTHUR. I appreciate that. In the interest of giving another member a chance to weigh in, I will yield back my remaining time.

Chairman HUIZENGA. The gentleman yields back.

With that, the gentleman from Illinois, Mr. Foster, is recognized for 3 minutes.

Mr. FOSTER. Yes. Thank you, Mr. Chairman. And I will try to be brief.

Professor Bullard, would you be more inclined to support a bill that allowed closed-end funds to be treated as well-known seasoned issuers if they were also restricted to be reporting companies under the 1934 act?

Mr. BULLARD. Well, that is a great question because it really hits on my differences, I think, with Mr. Stevens. He noted properly that closed-end funds are heavily regulated under the Investment Company Act regulatory regime. It is not clear why, with respect to offering rules, he wants to take them out of that regime and to put them in a regime where they don't belong.

For example, he made a comparison to closed-end funds filing quarterly reports as if they were similar to the 10-Qs filed by operating companies. Well, I would say if I—maybe if I sent a Christmas card to the SEC chairman every year, I might be considered to be filing annual reports, but I think that is about as close to filing a 10-K as a closed-end fund's quarterly report is to a real 10-Q.

So I think the place to do closed-end fund reform, and I would agree with many of the reforms that Mr. Stevens probably wants to accomplish, would be within that Investment Company Act regulation.



Mr. FOSTER. Thank you.

Now, Mr. Stevens, I am uncertain that the Investment Company Act disclosures adequately inform and update the markets to the point that they really justify a well-known seasoned issuer's status. Could you explain how current specific disclosures provide a continuous understanding of closed-end funds so that shelf-offering would be fully and adequately disclosed?

Mr. STEVENS. Well, I am astonished at Professor Bullard's comparison here. The SEC has developed reporting obligations based upon the nature of the activities of the reporter. Closed-end funds are investment pools. They are not operating companies. They don't have the kinds of activities, the range of activities, that an operating company would. So subjecting them to the same standards of an operating company is nonsensical. If there is a need for further reporting by closed-end funds or other registered investment companies, I am not aware of it, but the SEC can always enhance those reports.

I think, frankly, there is no absence of information about closed-end funds or other registered investment companies in the United States that is desired by the market. And the only reason then to use the well-known seasoned issuer and the kind of streamlining that has been provided to public operating companies is that these closed-end funds are also subject to the Securities Act of 1933. So they are within that regime. In fact, we always say in my space, we are subject to every one of the Federal securities laws. Public operating companies are not subject to the 1940 Act.

So I just think that the Chairman of the SEC, Mary Joe White, when she looked at this kind of treatment—in this case it was for the kind of closed-end fund that my colleague here, Mr. Gerber, is talking about, business development companies, but it could apply more broadly. She said making these changes, in her view, does not involve any compromise of investor protections. That is where we are.

Mr. FOSTER. Thank you. My time is up, and I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

The gentleman from Ohio, Mr. Davidson, is recognized for 3 minutes.

Mr. DAVIDSON. Thank you, Chairman. Thank you all for your testimony.

And, Mr. Quaadman, thank you for your advocacy across the country for small and medium businesses, and thanks for the focus on business development corporations.

Mr. MacArthur addressed some of the same things I would say as a businessman, and the importance of options. One option is no option, when it comes to capital and lots of other things. But with limited time, I want to say, could you address the impact the Volcker Rule has had on venture capital investment in the middle of the country? And, in addition, do you see a significant public policy reason for prohibiting financial institution investment into venture capital?

Mr. QUAADMAN. Yes. The Volcker Rule has caused a retrenchment of many different forms of capital formation that we would normally have expected to see financial institutions engaged in. It has made it much harder and more difficult for CFOs to access the

debt and equity markets. So our hope is, as has been called for by the Treasury Department, that the regulatory agencies are going to take another look at the Volcker Rule.

Venture capital has been under some stress from Volcker and from other areas as well. We believe that the capital formation report from the Treasury Department is actually putting forth some interesting recommendations for how to deal with this. We also have some concerns with some legislation that has been proposed in the past with beneficial ownership disclosure, that that is going to place another inhibitor on venture capital as well, which is one of the reasons why we have also opposed that.

Mr. DAVIDSON. Thank you. And I yield.

Chairman HUIZENGA. I am sorry. I was managing the members.

OK. I am sorry, did the gentleman yield back? The gentleman yielded back.

All right. With that, the gentleman from Indiana, Mr. Hollingsworth, is recognized for up to 3 minutes.

Mr. HOLLINGSWORTH. Well, good morning. I appreciate everybody being here, and I appreciate all the comments that were made early on, especially the compliments on the discussion draft that I am working on. I certainly won't take my full 3 minutes. I know much of this waterfront has been covered, especially by my partner in working in this, Mr. Foster, a few minutes ago.

But I just wanted to hit, again, Mr. Stevens, if you wouldn't mind commenting on, is there anything about this particular piece of legislation that you feel greatly endangers investors or otherwise dramatically reduces the amount of disclosure burden that we are putting on closed-end funds currently as I have proposed it so far?

Mr. STEVENS. To your first question, does it pose risks for investors? We would not be supporting it at the ICI if we believed that it was posing additional risk for investors, so no.

Mr. HOLLINGSWORTH. I was operating under the—I am asking the question I know the answer to philosophy.

Mr. STEVENS. I am sorry?

Mr. HOLLINGSWORTH. I said I am operating under the old lawyer—I am asking a question I know the answer to philosophy.

Mr. STEVENS. All right. And your second question is what benefits does it provide?

Mr. HOLLINGSWORTH. Yes.

Mr. STEVENS. It streamlines the issuance process. It allows closed-end funds to get to market more promptly in response to market conditions.

Mr. HOLLINGSWORTH. Right.

Mr. STEVENS. It facilitates their ability to communicate with the marketplace and with the investing public.

Mr. HOLLINGSWORTH. Right.

Mr. STEVENS. And hopefully, find a greater interest in the investment opportunities it is bringing to the market.

Mr. HOLLINGSWORTH. Right.

Mr. STEVENS. And I think those are all very favorable from the point of view of investors.

Mr. HOLLINGSWORTH. Yes.

Mr. STEVENS. And from the point of view, ultimately, of getting capital to work in our economy, creating jobs and economic growth.

Mr. HOLLINGSWORTH. Absolutely. And I think that is exactly the push that I have been making, right. The world is certainly not slowing down, opportunities come up and go away very, very quickly. I want these closed-end funds to be able to capture those opportunities.

And as for what was said before about whether closed-end funds are an appropriate vehicle or not for individual investors, I leave it up to those investors to make those decisions versus bureaucrats in D.C., or even legislators in D.C., deciding for people all the way across this country that might use these vehicles for specific purposes in fulfilling their financial needs.

And with that, I will yield back, Mr. Chairman.

Chairman HUIZENGA. The gentleman yields back.

With that, the gentleman from Ohio, Mr. Stivers, is recognized for 3 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. And I will be fairly brief too, because I know Mr. Rothfus wants to go.

My question is for Mr. Gerber. Mr. Gerber, can you explain why leverage is important and how you will use that to get more capital to businesses that want to expand, as well as to make better returns for your investors? And if you want to also talk about why—reinforce, again, how financial service firms allow you to help businesses that are below—help BDCs, help firms that are below their threshold for lending to get capital to smaller business, that would be great.

Mr. GERBER. Sure. So I will take those in order. And thank you, Congressman, not only for the question, but for your work on this bill.

In terms of the role that BDCs play in the capital markets, I mentioned in my testimony that most BDCs are deploying capital in the middle market, and that is a fast growing sector, very important from a job creation perspective. As I mentioned, from 2011 to 2017, more than 100 percent growth in job creation. So that is a very important role that BDCs play. And as my colleague, Mr. Quaadman, mentioned in his testimony, we are doing it at a time where other capital providers are not. So I think from a capital markets perspective, BDCs play an increasingly important role.

In terms of what we can do for our investors, again, as I mentioned earlier, it is an opportunity for us to deploy capital in ways that other investment vehicles do not, thereby giving investors an opportunity to invest differently and to build a more diversified portfolio with exposure to assets that aren't as correlated to the market as, say, a mutual fund would be.

To your question around how we can help smaller financial companies. I mentioned, in response to a question from the gentleman from Connecticut, there are portfolio companies within BDC portfolios that are able to lend to smaller businesses. We have them in our portfolio. And so as you scale as a BDC, it is harder to do smaller deals. It is just an issue of resources. And so larger BDCs tend to do larger deals. But if we can invest in portfolio companies that have the ability to do smaller deals or lend in ways that we don't lend, it is an opportunity for us to fund companies that are, in and of themselves, performing an important role in the capital markets.

Mr. STIVERS. Thank you very much.

And with my remaining 14 seconds, I will just say that Mr. Rothfus, who is about to ask questions, has done great work on H.R. 2319 that will help get—help allow a stable net asset value for a lot of folks who need that in their investment requirements.

I yield back the balance.

Chairman HUIZENGA. The gentleman's time has expired.

With that, our guest today, Mr. Rothfus, is recognized for 3 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman. And thank you for allowing me to participate in today's hearing.

I would like to just take a couple of minutes here and talk about my bill, H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017. And I would note the broad-based support we have gotten from across the country with over 200 groups and community leaders in support of this legislation.

I would like to offer for the record two letters, November 2, 2017, one from the Association for Financial Professionals, the other from the Association of School Business Officials International, to the committee.

Chairman HUIZENGA. Without objection.

Mr. ROTHFUS. Also, an October 3, 2012 article by Mr. Bullard on money market funds and life on support. I would like to offer that to the record as well.

Chairman HUIZENGA. Without objection.

Mr. ROTHFUS. Real quick, Mr. McCoy, to your earlier point whether we need to study this issue and the impact of this rule any further. We know what happened, right? \$1.2 trillion has moved out of the private and mutual fund sector into the treasuries?

Mr. MCCOY. That is correct. Yes. We have seen investors vote with their money and leave, yes.

Mr. ROTHFUS. There are cost benefits to any regulatory change, Mr. McCoy. Have the costs of this rule been justified?

Mr. MCCOY. I certainly believe so. It is an interesting question. I haven't totally focused on that, but I believe so.

Mr. ROTHFUS. In what sense? You are seeing an increase in borrowing rates for municipalities.

Mr. MCCOY. We absolutely are. We are seeing an increase—increased costs to issue variable rate debt into the money market funds, and that is filtered through our ability, State and local government's ability, to finance infrastructure at the lowest possible costs.

Mr. ROTHFUS. And, again, where has this money gone, out of the muni funds and out of the corp funds, where has it gone to?

Mr. MCCOY. Typically, it has gone into fixed rate bonds or, as I noted, there is an alternative product out there, a floating rate note, that is not eligible to be invested by 2a-7 funds, but that particular product does allow municipalities to participate at the short end of the yield curve where we get the best cost of funds.

Mr. ROTHFUS. Do you know whether money market funds that hold treasuries are immune to fluctuations and principal value?

Mr. MCCOY. I do not.

Mr. ROTHFUS. Mr. Quaadman, would they be—if you have a money market mutual fund holding just treasuries—let's say there

is a fund out there that has a million dollars in treasuries and somebody goes out, buys a million treasuries, starts to do this fund. Interest rate today is 1.43 percent, and the interest rate goes up tomorrow, what happens to the principal value in that money fund?

Mr. QUAADMAN. I would have to consult with some of our members and get back to you. I had not thought through that question. But let me do that and let me get back to you, if you want to—

Mr. ROTHFUS. Well, it makes sense that the principal value is going to fluctuate and it is going to go down. And while that Treasury bill a year from now, if it is a 1-year bill, is going to be worth a thousand bucks a bill, it is going to be stable in that sense, but it is going to change in principal value—

Mr. QUAADMAN. Yes.

Mr. ROTHFUS. —because of the fluctuation.

Mr. Chairman—

Chairman HUIZENGA. The gentleman's time has expired. And we are going to miss a vote here if we don't move quick.

So I would like to thank our witnesses for their testimony today.

Without objection, I would like to submit the following letter from Government Finance Officers Association and a number of others in support of Mr. Rothfus' bill.

Chairman HUIZENGA. Without objection, all members will have 5 legislative days within which to submit additional written questions for the witnesses to the Chair, which will be forwarded to the witness for their responses. I ask you all to please respond as quickly as you are able.

And, without objection, all members will have 5 legislative days within which to submit extraneous materials for the Chair for inclusion in the record.

This hearing is adjourned.

[Whereupon, at 10:53 a.m., the subcommittee was adjourned.]



# **A P P E N D I X**

November 3, 2017

Testimony of Mercer E. Bullard  
President and Founder, Fund Democracy, Inc.  
and  
Butler Snow Lecturer and Professor of Law  
University of Mississippi School of Law

before the

Subcommittee on  
Capital Markets, Securities and Investment

Committee on Financial Services

United States House of Representatives

*Legislative Proposals to Improve Small Businesses'  
and Communities' Access to Capital*

November 3, 2017



Chairman Huizenga, Ranking Member Maloney, members of the Subcommittee, it is an honor and a privilege to appear before the Subcommittee today. Thank you for this opportunity. I am the Founder and President of Fund Democracy, a nonprofit advocacy group for investors, and a Professor of Law at the University of Mississippi School of Law.

This testimony discusses aspects of three bills before the Subcommittee: the Consumer Financial Choice and Capital Markets Protection Act of 2017; the Expanding Investment Opportunities Act; and the Small Business Credit Availability Act. In summary, the third bill recognizes that business development companies (“BDCs”) are a form of special purpose investment company, both in terms of their unique status as reporting companies under the Exchange Act and their important role in providing credit to small- and mid-sized U.S. companies. The U.S. Securities and Exchange Commission has also recognized that BDCs are a different kind of investment company and, accordingly, has granted carefully crafted no-action relief from certain offering requirements and restrictions.

I agree that the SEC’s positions should be codified to allow BDCs to incorporate filings by reference, clarify their ability to conduct shelf registrations and grant automatic effectiveness to registration statements that reflect only nonmaterial changes. However, Congress should reconsider amending the legislation by simply requiring the SEC to adopt and/or amend its rules. Otherwise, there is a risk that the effect of the bill will be to create conflicts and ambiguity in what is currently a delicately balanced set of complex, interlocking rules.

The foregoing reforms identify actual problems that have been appropriately raised by the industry and refined and vetted in Congressional hearings, notwithstanding that the problems would be more efficiently and effectively resolved by requiring guided SEC rulemaking. In my opinion, the remaining BDC offering reforms in the bill, and especially the closed-end fund (“CEF”) offering reforms in the Expanding Investment Opportunities Act, do not reflect a considered solution to identified problems in offering regulation. These offering reforms generally cut and paste rules adopted under the Securities Act that were specifically designed for operating companies and apply them wholesale to two type of investment companies for which they are a poor fit. Under the

bills, the set of rules under which BDC and CEF offerings are conducted, and that are the actual source of any problems that the industry may have with securities offerings, would remain unchanged. This approach would create parallel regulatory regimes for BDC and CEF offerings that would create needless complexity and confusion.

This is especially true for closed-end funds. Closed-end funds are registered investment companies; BDCs, in contrast, are reporting companies, a kind of hybrid issuer. Reporting companies such as BDCs are subject to the full set of annual reports, quarterly reports and other filing requirements that apply to other operating companies. Closed-end funds are not subject to these rules. They are not hybrid issuers, but pure bred registered investment companies. Nor do CEFs serve a particular purpose in making capital available to what Congress views as an underserved capital market. There is no understanding that CEFs should receive special breaks, or a parallel offering regime, as a kind of quid pro quo. Unlike operating companies, which directly increase net social wealth, CEFs serve no ultimate end other than as facilitators of capital formation. Any perceived parallel between CEFs and BDCs does not reflect reality. There are good reasons that CEFs are less popular investment vehicles than mutual funds and exchange-traded funds, and those reasons are not regulatory. And if there are regulatory concerns, they should be addressed by dealing with their source, which lies in the rules under which they currently operate.

The bills would increase the amount of leverage that BDCs may use, which would make more capital available to the capital market they serve, but if this, alone, were a sufficient reason to increase the current 1:1 leverage limit, then there would no reason to have a leverage limit at all. Raising the limit – indeed, lowering the limit or setting any limit – can only be assessed if the costs and benefits of different levels of leverage are understood and should be implemented only if the benefits of any change exceeds the costs. I have previously testified before this Subcommittee on the importance of assessing the costs and benefits of regulatory reforms, and if incorporation by reference may be allowed for prior testimony as proposed for BDC filings, then I ask for such treatment of that testimony.

I have not mastered the literature on BDC leverage or conducted an empirical analysis of BDC portfolios, but my limited preparation for this hearing has revealed

significant potential problems with the proposal to double the BDC leverage limit. And the paucity of literature and empirical analysis on BDC leverage is the first problem that the Subcommittee should consider. We have recently experienced the effects of inadequately regulated risk-taking and the systemic threat that it may pose. Over the last 15 years, market declines have substantially undermined Americans' confidence in the markets. Allowing BDCs to double their leverage will necessarily significantly increase the risk that one or more BDCs will fail in the wake of significant market decline. Putting more BDCs in a position to become worthless as a result of a significant market drop may throw fuel on that fire.

As discussed further below, BDCs present a number of problems that Congress should consider before permitting BDCs to double their leverage. One problem is that we lack an adequate method of estimating BDC leverage and its effect. One industry measure suggests that effective BDC leverage is actually many multiples of the ostensible 1:1 limit. Needless to say, this means that BDCs' current risk disclosure may be grossly inadequate, and their estimates of their portfolio values' sensitive to market declines grossly understated. Additionally, it is not clear that current law allows BDCs to use the full leverage that the 1:1 ratio appears to permit. Congress should consider the reasons that BDCs typically keep a substantial buffer in place that keeps their regulatory leverage well below what is supposedly allowed. Other concerns are that many BDCs invest substantial assets in investments that are not consistent with their mandate and they charge extremely high fees. Finally, if Congress wishes to increase BDC investments in small- to mid-sized firms, it should consider substantially reducing the 30 percent of assets that BDCs may invest in other companies. It is not clear that the 30 percent basket serves any purpose in modern financial markets.

As for a prior proposal to allow BDCs to invest half of their assets in financial services firms that are not eligible portfolio companies, I note the irony that while Congress seeks to make more capital available to small- and mid-sized companies, this proposal would make less capital available to such companies. The financial services firm proposal contradicts the very *raison d'être* for BDCs, and it does so by diverting capital to firms that often provide services very similar or identical to the services provided by BDCs. If Congress believes that a social benefit that would be served by a

special purpose entity that invests half of its assets in financial services firms and half of its assets in small- and mid-sized companies, then it should create such an entity rather than destroy the already diluted identity that BDCs have spent almost 4 decades cultivating. It should also keep in mind that financial services firms do not create wealth by allocating capital, they only secondarily facilitate capital formation as intermediaries.

#### **I. Doubling the BDC Leverage Limit**

The bills would allow BDCs to increase their leverage ratio from 1:1 to 2:1. This would, as intended, make more capital available for BDCs to invest in the short-term. However, I am not aware of any reasoned basis for changing a decades-old standard, and there are many reasons why allowing increased leverage would be imprudent. Increased leverage is likely to have adverse long-term effects on the industry as a result of increased incidence of BDCs' incurring outsized losses or failing. It will pose significant risks for shareholders and abrogate the terms under which they made their investments. Current risk levels are poorly disclosed, and the leverage ratio itself is a crude measure that fails to reflect the reality of BDC leverage and the complexity of modern finance.

As discussed below, I have significant concerns regarding the proposal to allow BDCs to double their leverage. My concerns, due to the limited time available to prepare this testimony, are not, in all cases, fully formed, but they reflect genuine problems in the BDC industry that should be a much higher priority for Congress than granting BDCs more freedom to take greater risk.

##### **(a) High BDC Fees**

One concern is that BDCs are characterized by extremely high fees. The BDC registration statements that I reviewed show expense ratios consistently above 5.00 percent and, in some instances, significantly higher. For example, the manager of the largest BDC charges a management fee, income incentive fee, capital appreciation fee, and administrative fee.<sup>1</sup> The BDC's fee table that appears below<sup>2</sup> shows that total

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<sup>1</sup> Sample BDC Prospectus at 19 ("We [BDC A] may invest, to the extent permitted by law, in the equity securities of investment funds that are operating pursuant to

expenses, excluding interest on borrowings, are almost 6.5 percent of net assets:

<b>Stockholder transaction expenses (as a percentage of offering price):</b>	
Sales load	— (1)
Offering expenses	— (2)
Dividend reinvestment plan expenses	Up to \$15 Transaction Fee (3)
Total stockholder transaction expenses paid	— (4)
<b>Annual expenses (as a percentage of consolidated net assets attributable to common stock)(5):</b>	
Base management fees	2.64%(6)
Income based fees and capital gains incentive fees	1.71%(7)
Interest payments on borrowed funds	3.19%(8)
Other expenses	1.49%(9)
Acquired fund fees and expenses	0.61%(10)
Total annual expenses	9.64%(11)

This table does not show certain expenses. For example, it does not include

certain exceptions to the Investment Company Act and in advisers to similar investment funds and, to the extent we so invest, will bear our ratable share of any such company's expenses, including management and performance fees. We will also remain obligated to pay the base management fee, income based fee and capital gains incentive fee to our investment adviser with respect to the assets invested in the securities and instruments of such companies. With respect to each of these investments, each of our common stockholders will bear his or her share of the base management fee, income based fee and capital gains incentive fee due to our investment adviser as well as indirectly bearing the management and performance fees and other expenses of any such investment funds or advisers"). I would be happy to provide specific citations for this and other filings cited below to interested members.

<sup>2</sup> *Id.* at 16.

<sup>3</sup> These data assume that underwriters do not purchase any of their over allotment.

<sup>4</sup> The 0.61 percent ascribed to acquired funds represents those fees spread across the BDC's total net assets, i.e., over assets that are not invested in the acquired funds. The actual fees charged on the part of the BDC's net assets invested in the acquired funds would be up to 2.5 percent of assets and 25 percent of profits. *Id.* at 19 ("Certain of these Acquired Funds are subject to management fees, which generally range from 1% to 2.5% of total net assets, or incentive fees, which generally range between 1% and 25% of net profits."). At the end of 2016, the BDC had \$2.236 billion invested in "Investment Funds and Vehicles," which represented 43.05 percent of its net assets at that time. This category comprised 21.2 and 25.2 percent

underwriters fee that was paid in the offering made via this prospectus (0.70 percent of the \$750 million offering, or about 0.07 percent of net assets). Nor does it show the commission that would be paid on a purchase of common shares or the associated offering expenses (4.43 percent and 0.21 percent, respectively, in the BDC's 2014 \$235 million common stock offering, or about 0.16 percent of current net assets).<sup>3</sup>

The table also shows that the manager collects management fees on assets that *someone else is managing*. For this BDC, this double dipping amounts to 0.61 percent of the BDC's total net assets<sup>4</sup> – this fee would alone match the entire expense ratio for a reasonably priced mutual fund. The funds in which the manager invests the BDC's assets charge management fees ranging from 1.00 to 2.50 percent and performance fees ranging from 15 to 25 percent of net profits.<sup>5</sup> After those fees are paid, the BDC's manager collects those fees again.<sup>6</sup> Adding insult to injury, the manager may even collect fees on

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<sup>3</sup> These data assume that underwriters do not purchase any of their over allotment.

<sup>4</sup> The 0.61 percent ascribed to acquired funds represents those fees spread across the BDC's total net assets, i.e., over assets that are not invested in the acquired funds. The actual fees charged on the part of the BDC's net assets invested in the acquired funds would be up to 2.5 percent of assets and 25 percent of profits. *Id.* at 19 (“Certain of these Acquired Funds are subject to management fees, which generally range from 1% to 2.5% of total net assets, or incentive fees, which generally range between 15% and 25% of net profits.”). At the end of 2016, the BDC had \$2.236 billion invested in “Investment Funds and Vehicles,” which represented 43.05 percent of its net assets at that time. This category comprised 21.2 and 25.2 percent of BDC A's total assets at the end of 2015 and 2016, respectively. It appears that a large part of these investments were in two affiliated investment vehicles. The prospectus does not indicate whether the adviser itself collected any fees in connection with those investments.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* (“We [the BDC] may invest, to the extent permitted by law, in the equity securities of investment funds . . . and, to the extent we so invest, will bear our ratable share of any such company's expenses, including management and performance fees. **We will also remain obligated to pay the base management fee, income based fee and capital gains incentive fee to our investment adviser with respect to the assets invested in the securities and instruments of such companies.**” (emphasis added)).

income that the BDC never receives.<sup>7</sup>

While it may be more expensive to manage a BDC portfolio than other portfolios, this does not explain BDC expense ratios. There are bank loan funds and mutual funds that invest in very small companies that have expense ratios that are a fraction of BDC expense ratios. There are CEFs that have portfolios that appear to be quite similar to a typical BDC portfolio that have much smaller expense ratios. In some cases, BDC sponsors offer a similar CEF but charge substantially less to their CEF than they charge to their BDC.

In some cases, BDC expenses are significantly increased by fees paid to other investment vehicles. It is not clear how allowing BDCs to invest in other investment vehicles fulfills their purpose. For example, as noted above, the BDC that incurs 0.61 percent of net assets in fees on funds in which it invests appears to have approximately one-quarter of its assets invested in underlying investment vehicles. Some of these underlying investment vehicles are affiliated with the BDC manager. It appears that the BDC manager may itself be collecting fees in connection with the management of the underlying fund, thereby exacerbating what already constitutes substantial double dipping.

When a BDC makes a public offering, the fees can easily exceed 10% of the amount invested. For example, a BDC recently conducted an initial public offering that included a 4.00 percent commission, a 1.00 percent maximum contingent deferred sales charge, 1.00 percent in offering expenses, an annual 1.33 percent trailing commission,<sup>8</sup> a

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<sup>7</sup> *Id.* at 36 (“The income based fees payable by us [the BDC] to our investment adviser that relate to our pre-incentive fee net investment income is computed and paid on income that may include interest that is accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of such fee will become uncollectible. ***Our investment adviser is not under any obligation to reimburse us for any part of the income based fees it received that were based on accrued interest that we never actually receive.***” (emphasis added)).

<sup>8</sup> The BDC represented that the distribution fee would comply with Rule 12b-1 under the Investment Company Act, but such compliance is not required (and for

2.75 percent management fee, a 0.37 percent incentive fee, and a 0.85 percent fee representing other expenses. The estimated shareholder expenses for a one year investment were \$109 of every \$1,000 invested (10.9%) and, if the shares were sold after one year, \$115 of every \$1,000 invested (11.5%). And this fund was not investing in equities, where it is conceivable (albeit highly unlikely) that investment returns could make up for such large first-year expenses, but in debt, where making up for expenses, if ever, would take many years.

**(b) Outdated Leverage Measure and Undisclosed Leverage Ratio**

A second concern is that the 1:1 leverage ratio is woefully outdated and potentially misleading. When Congress adopted the CEF 1:1 leverage for BDCs, it did so at a time when understanding the capital structure of a company did not require a finance PhD. Almost 40 years later, complex capital structures may have rendered the 1:1 leverage limit meaningless for both BDCs and their portfolio companies. While BDCs purport to adhere to this limit, their actual leverage ratios not only may be substantially higher, but *many multiples* higher than 1:1.

Industry professionals have recognized the misleading nature of the BDC 1:1 leverage limit. In the words of banking analysts:

In our view, the raw leverage measure (debt/equity) doesn't tell the whole story as the loans that BDCs hold have various degrees of implicit leverage.<sup>9</sup>

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mutual funds, a 12b-1 fee cannot exceed 1.00 percent). *See generally LPL to Limit Fees on Non-Traded REITs and BDCs*, thediwire.com (June 7, 2017) (limiting annual trailing commissions to 1 percent) *available at* <https://thediwire.com/lpl-to-limit-fees-on-non-traded-reits-and-bdcs/>.

<sup>9</sup> Wells Fargo 4Q17 BDC Scorecard at 14. The “implicit leverage” includes, for example, the leverage embedded in the capital structure of the BDC’s portfolio companies. To illustrate, a \$100 million 1<sup>st</sup> lien senior secured loan to a portfolio company presents far less risk than a \$100 million subordinated unsecured loan, all other factors being equal. A BDC that routinely invests in the latter rather than the former will have a higher effective leverage ratio and be a riskier investment.



For example, a widely used industry publication found that some BDCs currently have effective leverage in excess of 5:1 – more than 9 times that of the least leveraged BDC considered.<sup>10</sup> As recently as 2015, the publication found BDCs with leverage in excessive of 7.5:1, with 12 of 25 BDCs evaluated boasting leverage in excessive of 4:1.<sup>11</sup> Effective leverage ratios ranging from 4:1 to 7.5:1 (if not higher) suggest that the 1:1 leverage limit is misleading and SEC disclosure requirements are grossly inadequate. It also means that BDC illustrative disclosure of the effect of a market decline on share value grossly understates the amount of potential losses. Before Congress considers allowing BDCs to increase their leverage, it should ensure that the BDCs' current level of risk is accurately estimated and adequately disclosed. Neither is currently the case.

(c) **Effect of Doubling BDC Leverage**

A third concern is that doubling the leverage allowed to BDCs will significantly increase the incidence of large losses and BDC failures. To illustrate, the table below shows how portfolio losses in a leveraged BDC would translate into much higher investor losses. This is the ineluctable effect of leverage, and the losses in the table would be substantially higher, of course, if the BDC were allowed to double its leverage.

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<sup>10</sup> Wells Fargo 4Q17 BDC Scorecard at 16 (showing, as of Sep. 11, 2017, effective leverage for 25 BDCs ranging from 0.56 to 5.20).

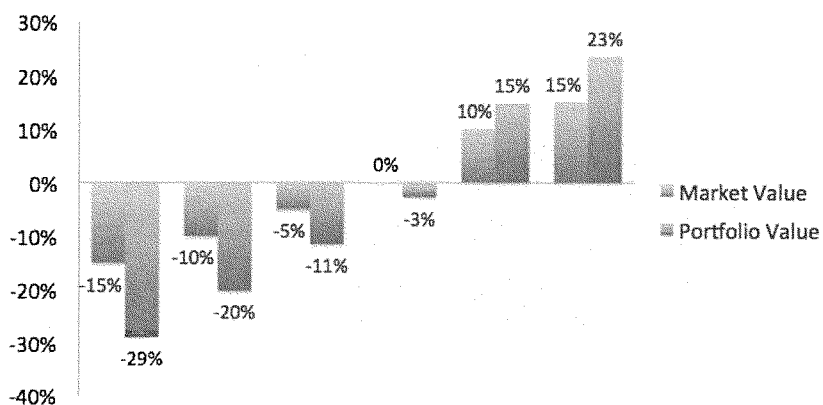
<sup>11</sup> Wells Fargo 4Q15 BDC Scorecard at 12. Two days ago, an equity research firm released a statement on the BDC that had the 7.5+1 effective leverage ratio in 2015 that stated:

Stock likely headed lower on severe credit weakness, NAV degradation, and dividend cut. Announced dividend reduction from \$0.45 to \$0.30/share appears warranted ***given credit induced earnings stress***. The Board has begun to explore strategic alternatives including the sale of certain assets as well as the potential benefit of partnering with another organization.

Baird Equity Research (Nov. 2, 2017) (emphasis added).

Assumed Return on Portfolio (Net of Expenses)(1)	-15%	-10%	-5%	0%	5%	10%	15%
Corresponding Return to Common Stockholders(2)	-28.93%	-20.20%	-11.48%	-2.75%	5.97%	14.69%	23.42%

As noted, this table probably understates the losses that would be incurred if all sources of effective leverage were considered, such as the relative priority of loans to portfolio companies, and it does not include a truly significant market decline (e.g., -30 percent). In addition, the SEC should require that this table be presented in a bar chart, as is required for mutual funds, in order to make it intuitively understandable. The same table appearing above is shown as a bar chart below.



In fact, it is likely that raising the leverage ratio will *more* than double BDCs' risk level. The interest rate that a BDC pays on borrowing (or dividend preference on preferred shares) is based, in part, on the degree of risk presented by the BDC. When a BDC increases its riskiness by increasing its leverage, it will necessarily incur a higher cost of capital in the form of higher interest rates and/or dividend preference terms. For

example, banks, which typically make loans to BDCs subject to a 1:1 leverage limit,<sup>12</sup> will charge a higher interest rate to BDCs that may exceed the 1:1 limit. When a BDC pays more in interest, it must make riskier (subordinated) loans and/or loans to higher risk borrowers in order to maintain the same level of income and distributions to shareholders. While in good economic times shareholder returns will be even more inflated, in a downturn, BDCs are far more likely to fail. A decline in the value of a BDC's portfolio of only one-third may be sufficient to wipe out the fund.

**(d) Investing in Non-Eligible Companies**

A fourth concern is that some BDCs are not investing consistent with their statutory purpose. I have not had time to do an empirical analysis of BDC portfolios, but it appears that some BDCs have invested heavily in collateralized debt obligations ("CLOs").<sup>13</sup> These securities are not typically sold in the narrower capital markets in which small- and mid-size company debt is bought and sold. Rather, CLOs are funded by a large variety of investors and exhibit no lack of liquidity. The CLO market is not the market that BDCs were intended to serve. It also appears that the larger BDCs may be buying small pieces of debt tranches in which a wide variety of investors participate. Again, this is not the market that BDCs were intended to serve.

While the 30-percent basket that BDCs may fill with ineligible investments may have provided flexibility needed many decades ago, it is not clear why it is needed today. The most direct way to increase BDC lending to small- and mid-sized companies would be to reduce the 30-percent basket to 20 or 10 percent. The market for BDC shares is well-established, including the market perception that BDCs are a particular type of asset and that BDCs compete against other BDCs. I am not aware of any compelling evidence that BDCs still need the 30 percent basket, but this question needs study. Reducing this percentage may make the BDCs that are truly committed to this market more competitive

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<sup>12</sup> Wells Fargo Equity Research at 3 (Nov. 2, 2015) ("many bank credit facilities to BDCs have 1:1 debt/equity covenants").

<sup>13</sup> Wells Fargo 4Q15 BDC Scorecard at 14 (BDC with a 2015 effective leverage ratio of "has a large portion of CLO equity, which in itself has higher amounts of leverage.").

with those BDCs that are not.

**(e) Reasonable Shareholder Expectations**

A fifth concern is that raising the leverage limit abrogates the deal that shareholders struck when they invested in a BDC. Investors bought their shares on the basis of a statutory leverage limit that the BDC could not alter. Now they will be confronted with having to sell their shares, possibly at a discount to net asset value that has grown larger in response to the BDC's increase in risk, thereby incurring an immediate tax, or stay in a fund that does not match their investment needs and experiences a significant decline in dividends. Non-traded BDC shareholder will not even have the opportunity to sell their shares.

The bills' leverage provision does not adequately protect shareholders' rights. For publicly-traded BDCs, *no shareholder approval* is required, so shareholders will have no say in whether a fundamental term of their investment is changed. Even with shareholder approval, as would be available for non-traded BDCs, dissenting shareholders will not even have the rights afforded to shareholders under corporate law. Although the BDC is required to offer to repurchase 25 percent of its shares for four quarters, there appears to be no requirement that shareholders be paid net asset value. Shareholders of BDCs that change such a fundamental investment policy should be allowed to vote on the change, and dissenting shareholders should have the immediate option of redeeming their shares at net asset value.

**(b) Alternative Options**

A sixth concern is that there may be a more appropriate way to allow BDCs to increase their leverage. It appears to be common practice for BDCs to keep a significant buffer between their regulatory leverage ratio and the 1:1 limit. This does not appear to reflect the fear that the BDC will violate the limit not by over-borrowing, but by experiencing a decline in asset values that causes its ratio to exceed 1:1. The leverage limit appears to require only that the BDC refrain from additional borrowing until it is back under the limit. It appears that BDCs are not permitted to pay dividends when

above the 1:1 limit, which might explain the buffer. If this is the case, then it may be appropriate, in my view, to permit them to pay dividends when over the limit as long as the dividends are paid out of income. If a BDC is over the limit, the receipt and immediate distribution of income would not adversely affect the BDC's starting leverage position. It may also be that the term structure of BDC borrowing results in a need to rollover short-term debt, and the leverage limit would be temporarily violated pending the liquidation of the expiring loan. If so, that problem could be fixed by allowing a grace period, up to a higher leverage limit perhaps (e.g., 1.2:1) during which debt could be rolled over as long as the BDC's leverage was no higher after the rollover than it was before. If the problem is bank loan covenants, the Subcommittee should inquire as to why these covenants are not structured along the lines above.

In short, the nature of a leverage limit in many contexts – banking, insurance, money market funds, etc. – is such that compliance generally should be able to be achieved without having to maintain a large buffer. Otherwise, the leverage limit is not actually the limit. A 1:1 leverage limit becomes a de facto 0.7:1 limit. I recognize that this discussion may be missing the reason for the buffers, but my sense is that there should be a way to allow BDCs to use the full limit prescribed by Congress. This alone would free up additional capital for investment.

## **II. Offering Rules**

In 2005, the SEC adopted rules that were generally designed to liberalize securities offerings by operating companies and not designed for investment companies. Investment companies are regulated under a separate set of rules that are specifically tailored to such entities. For this reason alone, allowing CEFs and BDCs to rely on rules designed for operating companies is generally not an appropriate approach to securities offering reform.

The 2005 reforms were generally designed to address the problem of company communications being restricted or prohibited when the company is “in registration.” A company is generally deemed to be “in registration” if it is planning to issue securities. Under the Securities Act, a company is generally prohibited from making *any* offers of

securities, orally or in writing, unless a registration statement has been filed with the SEC. The term “offer” is interpreted broadly – so broadly, in fact, that the pre-registration period is known as the “quiet period.” Oral offers are permitted after a registration statement has been filed, but written offers (confusingly called “prospectuses”) continue to be subject to restrictions.

The 2005 reforms addressed limits on communications that might be deemed to be offers by creating safe harbors for certain communications. The safe harbors are designed for operating companies, not investment companies, and they are further divided between rules for initial offerings and rules for offerings by reporting (public) companies (and further for reporting companies by size). For example, Rule 169 allows non-reporting issuers to release factual (i.e., not forward-looking) information prior to filing a registration statement if they routinely release the same type of information in the same manner. Rule 168 allows reporting companies to release factual *and* forward-looking information prior to filing a registration statement if they routinely release the same type of information in the same manner. Rule 163 allows well-known seasoned issuers (“WKSIs”) to make offers prior to filing if the offer qualifies as a “free writing prospectus” and includes a cautionary legend. Rule 163A allows companies to release any type of information more than 30 days prior to filing a registration statement provided that the communication does not refer to the securities offering and the company takes reasonable steps to prevent dissemination of the communication within 30 days of the offering.

Mutual funds, closed-end funds and BDCs (and certain other types of issuers) are subject to different offering rules that are designed to reflect the differences between operating companies and investment companies. This presents the most significant concern regarding the proposed offering reforms. Closed-end funds and BDCs would become subject to two separate offering regulatory regimes and, apparently, be allowed to pick and choose which would apply. More to the point, they would be able to evade requirements that are specifically designed for non-reporting issuers such as registered investment companies by opting for a set of rules that were not written with investment companies in mind.

As noted above, the proposed offering reforms are particularly inappropriate for CEFs. Unlike BDCs, CEFs are not reporting companies. They do not file the reports that operating companies file under the Exchange Act. They file reports and use registration statements that are designed to reflect their nature as investment pools. The ICI has suggested that quarterly reports filed by CEFs are similar to quarterly reports filed by operating companies.<sup>14</sup> I think the ICI protests too much. Let's consider this comparison. The quarterly report filed by CEFs, Form N-Q, is nothing more than a certified list of portfolio holdings. Operating companies file Form 10-Q, which requires a discussion of legal proceedings (Item 1), risk factors (Item 1A), unregistered sales of equity securities and use of proceeds (Item 2), defaults upon senior securities (Item 3), and any other item that would be required to be disclosed on Form 8-K, which in turn requires disclosure of Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant (Item 2.03), Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement (Item 2.04), Costs Associated with Exit or Disposal Activities (Item 2.05), Material Impairments (Item 2.06), Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing (Item 3.01), Unregistered Sales of Equity Securities (Item 3.02), Material Modification to Rights of Security Holders (Item 3.03), Changes in Registrant's Certifying Accountant (Item 4.01), Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review (Item 4.02), Changes in Control of Registrant (Item 5.01), Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers (Item 5.02), Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year (Item 5.03), Temporary Suspension of Trading Under Registrant's Employee Benefit Plans (Item 5.04), Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics (Item 5.05), Change in Shell Company Status. Submission of Matters to a Vote of Security Holders (Item 6.01); Shareholder Director Nominations, ABS Informational and Computational Material.

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<sup>14</sup> See ICI Testimony at 3 ("Like most publicly traded operating companies, closed-end funds file annual and semi-annual reports as well as quarterly reports. Each of these reports includes certifications from the principal executive officer.").

Change of Servicer or Trustee (Item 6.02), Change in Credit Enhancement or Other External Support (Item 6.03), Failure to Make a Required Distribution (Item 6.04), Securities Act Updating Disclosure (Item 6.05), Static Pool (Item 6.06), Regulation FD Disclosure (Item 7.01). A CEF's Form N-Q and an operating company's Form 10-Q are both filed quarterly. Any similarity ends there.

The comparison is also made to the registration process for mutual funds and interval funds on the one hand, and CEFs on the other.<sup>15</sup> Both mutual funds interval offer their shares for redemption, and both redeem shares at their net asset value. These entail registration and transactional burdens that CEFs do not approach. The idea that the registration burdens of mutual funds and interval funds is somehow lighter than it is for CEFs is ludicrous. Closed-end funds have been unsuccessful *despite* the significantly lower regulatory costs that they incur relative to other open-end investment vehicles. The CEF structure is simply not a structure that shareholders prefer; lipstick-on-a-pig offering reforms will do nothing to change that fact.

Closed-end funds are exempt from certain requirements that apply to reporting companies and would continue to be exempt under the proposed reforms. Unlike BDCs, CEFs register under the Investment Company, where Congress placed a set of requirements regarding the issuance of shares by mutual funds, closed-end funds and unit investment trusts that it designed for those types of issuers. The only logical arena within which to amend CEF offering rules is within the existing framework under which they are regulated. I am not aware of a similar package of proposals to that framework having been presented, the preference apparently being for the more lax environment that cherry-picked operating company rules offer. The application of operating company offering rules to CEFs seems to reflect a last-minute attempt to piggy back on changes being proposed for BDCs, which are fundamentally different in their regulation and purpose.

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<sup>15</sup> *Id.* at note 7 (noting eligibility of mutual funds and interval funds for immediate effectiveness). This is not to say that nonmaterial CEF filings should not be made immediately effective. Rather, they should be regulated within the set of rules that were designed for registered investment companies.



Some appear to believe that CEFs are entitled to offering reform because they have not been very popular with investors. This reasoning is hard to follow. Closed-end funds do not, in and of themselves, represent a public good that Congress should seek to make more popular. The regulation of BDCs reflects a conscious decision by Congress to increase a particular type of investing, in part by loosening certain Investment Company Act provisions. Closed-end funds are nothing more than a legal structure used for the intermediation of investment dollars. It does not make sense to lower the leverage limit that applies to closed-end funds simply to make them more popular when they are less popular for good reason. Closed-end funds are poor cousins to mutual funds and, more recently, their upstart nephews, exchange-traded funds, because they often trade at large discounts to the net asset value, they charge high fees, and their managers are less accountable to the marketplace because their shares are not redeemable. Their unpopularity has nothing to do with offering restrictions and is not a rational basis for creating an artificial advantage for them relative to mutual funds, exchange-traded funds, separate accounts, collective investment trusts and hedge funds.

In contrast, there is merit in some of the concerns that appear to have prompted the proposal for wholesale application of operating company offering rules to BDCs. This largely reflects the fact that BDCs, unlike CEFs, are reporting companies, and Congress made them reporting companies as part of a regulatory structure that it designed to facilitate investment in small- and mid-sized companies. Their status as reporting companies already creates at least a regulatory congruence with operating company regulation that does not exist for registered investment companies such as CEFs. The same type of information, at the same time intervals, is made available under Exchange Act reporting by BDCs as for operating companies that rely on operating company offering rules. Furthermore, the SEC has permitted BDCs to engage in the same practices that the key proposals appear to be designed to codify. And BDCs, unlike CEFs, are investment vehicles that serve a specific policy goal.

Along this reasoning, in my view BDCs should be afforded three benefits that properly reflect their reporting company status. First, they should be able to incorporate documents by reference. As noted, as reporting companies BDCs are subject to the kind

of continuous reporting that applies to operating companies, which are already permitted to incorporate by reference. Second, BDC registration statements that contain no material changes should become automatically effective upon filing<sup>16</sup> (I would reconsider this position if the SEC demonstrated that its review during delayed effectiveness has uncovered abuses relating to nonmaterial changes). Third, BDCs should be allowed full use of Rule 415's shelf registration provisions, although not under the ill-fitting guise of a Form N-2 Registration statement.<sup>17</sup> As the SEC has previously allowed, they should be subject to the same standards that apply, for example, to eligible Form S-3 filers.

In each case, however, it is not appropriate for Congress to specify the administrative law means by which the practical goals described above are achieved. Rather, Congress should simply instruct the SEC to adopt and/or amend rules as needed to accomplish these goals. Granted, the SEC's rulemaking paralysis may necessitate tying this instruction to a deadline after which the new standard becomes self-executing. But I am confident that allowing the SEC to determine how to navigate the most efficient way to accomplish these goals will result in rules that work better than legislated reforms for the industry and shareholders alike.

### **III. Proposed 50 Percent Limit for BDC Investments in Financial Firms**

Prior versions of the bills would have permitted BDCs to invest up to 50 percent (or more) of their assets in financial firms that are not eligible investments. As this

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<sup>16</sup> The SEC has essentially permitted automatic effectiveness under certain no-action letters. See Nuveen Virginia Premium Income Municipal Fund (Oct. 6, 2006); Pilgrim American Prime Rate Trust (May 1, 1998).

<sup>17</sup> The Offering Rules Provisions create the impression that CEFs and BDCs are not currently allowed to conduct shelf offerings under Rule 415. In fact, CEFs and BDCs *routinely* conduct shelf registrations under Rule 415. For example, as recently as 2014, almost every BDC (79 out of 88) conducted at least one shelf offering under the rule. There has been no practical impediment to BDCs' conducting shelf offerings. For over two decades, CEFs and BDCs have relied on SEC no-action letters that permit them to conduct shelf offerings under Rule 415. The actual effect of the proposed shelf offering reforms would be to allow CEFs and BDCs to circumvent the long-established, carefully considered conditions under which the SEC has already allowed shelf offerings by these funds.

proposal may resurface, I am compelled to wonder why Congress would choose to make BDC less likely to serve their legislative purpose and more likely to lose the interest of shareholders. The reason for reduced regulation of BDCs is to make additional capital available to small- and mid-sized operating businesses. Allowing BDCs to increase their investments in financial firms would do the opposite. Every dollar that a BDC invested in a financial firm is a dollar that would be denied to the intended beneficiaries of BDCs' regulatory regime.

One BDC witness has illustrated precisely this point. He stated that, due to the existing 30% limit on investments in financial firms, "a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context feels quite arbitrary." In other words, the BDC would not be allowed to divert more assets to a financial business that was doing what the BDC is supposed to do: make capital available to small- and mid-sized businesses.<sup>18</sup>

Permitting BDCs to invest 50% of their assets in financial services firms may destroy BDCs as a unique asset. Imagine a period in which financial firms perform well, while small- and mid-sized firms perform poorly. The market will view BDCs that hold a large percentage of financial stocks as better-performing "BDCs," while the rest are viewed, unfairly, as poorly-performing "BDCs." In fact, their relative performance would have little to do with their identity as BDCs. That term will have essentially lost

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<sup>18</sup> For example, the largest BDC has an \$88.4 million investment (representing 1.7% of the fund's assets) in 10<sup>th</sup> Street LLC. See Sample BDC Prospectus at F-25. The webpage for 10<sup>th</sup> Street LLC describes it as having been founded "with the goal of providing capital to companies in the lower middle market." At <http://www.tenthstreet.com/> (last visited Oct. 29, 2017). See also *id.* ("For over a decade, Tenth Street has been giving transaction support to equity sponsors by providing mezzanine debt and equity co-investments. Now investing out of a seventh fund, Tenth Street has raised almost \$400 million in committed capital and provided it to growing companies in the lower middle market."). The website for another of the BDC's investments -- Imperial Capital Private Opportunities -- describes itself as "a Toronto-based private equity fund manager that focuses on investment opportunities in healthcare, business services, and consumer products in the Canadian and American mid-market." At <http://imperialcap.com/> (last visited Oct. 29, 2017).

any real significance. The effect will be to strip all meaning from the concept of the BDC election – a concept that is likely already being substantially eroded under the current 30 percent limit. If BDCs are not held to their purpose, there is no reason to have BDCs.

#### **IV. Money Market Fund Reforms**

I testified before this Subcommittee on money market fund reforms before they were adopted by the SEC. My views have not changed, but circumstances have. Dozens of money market funds have closed, hundreds of billions of dollars of credit that had been extended to businesses have been diverted to the U.S. government, and institutional investors looking to find a short-term home for their cash have been forced to reevaluate their longstanding preference for money market funds.

Notwithstanding such adverse effects, I cannot support the current proposal absent an empirical analysis of the after-effects of the money market fund rulemaking. Just as the original rules were adopted with an inadequate understanding of their effect, Congress should not rush turn back the clock without know the effect of doing so. The SEC intends to analyze the effect of the reforms, and I believe, in light of what I viewed as an errant perspective the first time around, that the agency might benefit from direct instructions from Congress as to the relevant questions that it should answer.<sup>19</sup> In short, my position is similar to Chairman Clayton's, who has opined that "it's too early to say we're wrong." I recognize that it's too early to say I was right.

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<sup>19</sup> This should include an analysis of the current status of the SEC's longstanding, extra-judicial practice of granting ad hoc, last minute, oral no-action relief to MMFs that were at risk of imminent failure. I refer the Subcommittee to the comment letter I submitted to the SEC eight months prior to the collapse of the Reserve Fund that warned that the developing credit crisis warranted immediate action to protect MMFs, including specifically a re-evaluation of the staff's ill-advised no-action practices. Indeed, the SEC's excessive reliance on no-action positions, and concomitant failure to codify their positions, is one reason that the pending bills have been proposed. SEC rulemaking paralysis continues to be a significant problem at the agency, as I have also discussed in prior testimony before the Subcommittee.

I am also concerned about the bill's restrictions on banking regulators' ability to take emergency action in the event of another severe liquidity event. While we might believe today that such action is inappropriate, we might take a different view upon the onset of another financial crisis. By analogy, the Delaware courts have held that it is not consistent with a corporate director's fiduciary duty to adopt a poison pill to frustrate a hostile takeover that no future board member can change. Such poison pills, appropriately named "dead hand" provisions, are impermissible because they prevent future board members from taking steps that they deem to be in the best interests of shareholders. It is a dangerous practice to remove emergency powers from the set of tools we have to mitigate financial crises.

I understand that tying banking regulators' to the mast, so to speak, may signal to investors that MMFs will not be bailed out in the future. However, I doubt very much that this will influence investors' behavior or attitudes. And this approach may backfire in the event that banking regulators are unable to prevent a full-blown run on MMFs, which may lead to the systemic meltdown we recently so narrowly avoided. Treasury bailouts are not all bad, or even "bailouts." It is worth recalling that the U.S. Treasury pocketed more than \$1 billion insurance premiums paid by MMF shareholders without paying a single penny in claims.

There are structural checks that Congress could use to ensure proper oversight of banking regulators' exercise of emergency powers without making those powers practicably unavailable. A common approach is to make the exercise of power contingent on certain findings being made, which could be required of the heads of multiple agencies (this is the approach that Congress used after the 1980s banking crisis to impose tighter discipline on FDIC decisions on whether to allow weak banks to remain in business). Banking regulators could be required to submit proposed actions to a process that allowed Congress – perhaps initially through a designated committee, which then could pass a recommendation for further action by the full body – to intercede without preventing the prompt action that is sometimes needed to right the ship before it sinks. It is almost always more workable to authorize emergency action in advance while

providing for a shut-off valve, than to prohibit emergency action that must be legislatively restored to be used in an emergency.

SUBCOMMITTEE ON CAPITAL MARKETS,  
SECURITIES, AND INVESTMENTS

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

HEARING ON: "LEGISLATIVE PROPOSALS TO IMPROVE SMALL BUSINESSES' AND  
COMMUNITIES' ACCESS TO CAPITAL"

NOVEMBER 3, 2017

TESTIMONY OF

MICHAEL F. GERBER  
EXECUTIVE VICE PRESIDENT  
FS INVESTMENTS

### **Introduction to FS Investments**

Chairman Huizenga, 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 FS Investments (“FS”), and also serve on the Board of Directors of the Small Business Investor Alliance, the premier membership organization representing Business Development Companies (“BDCs”).

FS, founded in 2007 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 only to wealthy individuals and large institutional investors. In serving our primarily retail (individual) shareholder base, 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. We manage five BDCs, one closed-end fund, two interval funds and one mutual fund. In all, we manage more BDC assets, in both traded and non-traded BDCs, than any other manager in the industry.<sup>1</sup>

### **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.<sup>2</sup> Congress’ 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.<sup>3</sup> 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 capitalizations of less than \$250 million.<sup>4</sup> 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.<sup>5</sup> 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, 93 BDCs from across the industry have more than \$90 billion invested.<sup>6</sup>

In addition to helping fill a void in the capital markets for small and middle market companies, BDCs are highly regulated, transparent investment vehicles that provide individual investors access to an asset class which historically had been available only to wealthy individuals and institutional investors such as university endowments, foundations and pension funds. This access provides an important opportunity to all investors as a generator of current income within a portfolio.

### **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

<sup>1</sup> FS currently manages five BDCs with aggregate assets under management of approximately \$18.2 billion as of June 30, 2017. FSIC, our first fund which launched in January 2009, listed its shares of common stock on the NYSE in April 2014.

<sup>2</sup> 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.

<sup>3</sup> *See* S. REP. NO. 96-958, at I, 3 (1980).

<sup>4</sup> *See* 15 U.S.C. § 80a-2(a)(46), -54.

<sup>5</sup> *Id.* §80a-2(a)(48)(B).

<sup>6</sup> SBIA BDC Council, [www.bdcsworkforamerica.org](http://www.bdcsworkforamerica.org).



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. 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, interest rates, and current fair value for each investment. As a result, BDC investment portfolios are marked-to-market in the financial statements and disclosed to investors quarterly. 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.

These extensive and comprehensive 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 payment of distributions to investors, custody of assets and codes of ethics. Finally, investment advisers to BDCs must register with the Commission under the Investment Advisers Act of 1940, which imposes a fiduciary obligation on the adviser to act in the best interest of the BDC.

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 U.S. Territories through the review of their public securities offering documents and the imposition of suitability standards for investor participation in those 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 various other regulations applicable to BDCs make BDCs one of the most transparent and highly regulated investment vehicles available to investors today.

#### **BDCs Are Critical Middle Market Lenders**

While BDCs are an important source of capital for small businesses, they have become a critical source of capital for middle market businesses as well.<sup>7</sup> Nearly 200,000 U.S. businesses comprise the middle market, which is responsible for one-third of America’s private sector gross domestic product.<sup>8</sup> Middle

<sup>7</sup> 3Q 2017 Middle Market Indicator, National Center for the Middle Market.

<sup>8</sup> *Id.*

market businesses, defined as those with annual revenue between \$10 million and \$1 billion, employ nearly 48 million people,<sup>9</sup> or one out of every three workers in the private sector.<sup>10</sup>

Middle market firms are the engines of the U.S. economy. American Express and Dun & Bradstreet report that, despite accounting for just 1% of commercially active companies in America, the middle market created over half of all new jobs since 2011.<sup>11</sup> In fact, the middle market generated 103.3% job growth between 2011 and 2017 compared to 52.3% for large firms and just 7.4% for small businesses over the same period.<sup>12</sup> Similarly, over the last year, middle market firms increased hiring by 6.4%, while large firms grew headcount by 2.8% and small firms grew by only 1.2%.<sup>13</sup> Importantly, middle market growth is increasingly benefiting underrepresented populations and geographies. Since 2011, the numbers of women-owned and minority-owned middle market companies have grown by 119.6% and 85.8%, respectively.<sup>14</sup> Middle market growth has also been particularly robust in legacy industrial states such as Ohio and Michigan, which were hit hard during the Great Recession but have seen triple-digit growth in their middle markets due to a resurgence in manufacturing and wholesaling over the last six years.<sup>15</sup> Capitalizing on this small manufacturing renaissance, the number of middle market firms exporting their goods and services has quadrupled over the last six years.<sup>16</sup> Behind the scenes, the recovery of the middle market in Ohio and Michigan was made possible by BDC investments in these states totaling over \$1.6 billion and \$1 billion, respectively.<sup>17</sup>

The success of this middle market growth story is fueled by investment, and 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 42% of middle market companies expect to add more jobs in 2018.<sup>18</sup> The National Center for the Middle Market estimates this will translate into another 6.0% revenue expansion across U.S. middle market firms over the next year.<sup>19</sup> A record 70% of middle market firms surveyed by the National Center for the Middle Market reported that they would immediately invest extra cash rather than save it, with capital expenditures and employee training and development topping the list for investment.<sup>20</sup> Despite this obvious need and the importance of a healthy and growing middle market to the overall U.S. economy, bank lending to small and mid-sized businesses dropped 38% between 2006 and 2015.<sup>21</sup> Middle market lenders, like BDCs, must be positioned to fill the void left by banks and provide the capital necessary to fuel the middle market's continued growth.

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 need to continue to grow revenue and create new U.S. jobs.

#### **The "Small Business Credit Availability Act"**

FS believes the discussion draft of the "Small Business Credit Availability Act" includes modest, common-sense amendments that would enable BDCs to enhance their ability to provide capital to small

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> Middle Market Power Index, August 2017, American Express Global Corporate Payments and Dun & Bradstreet.

<sup>12</sup> *Id.*

<sup>13</sup> 3Q 2017 Middle Market Indicator, National Center for the Middle Market.

<sup>14</sup> Middle Market Power Index, August 2017.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> SBIA BDC Council, [www.bdcsworkforamerica.org](http://www.bdcsworkforamerica.org).

<sup>18</sup> 3Q 2017 Middle Market Indicator, National Center for the Middle Market.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> "Big Banks Cut Back on Loans to Small Business." Ruth Simon. The Wall Street Journal. November 26, 2015.

and mid-sized U.S. companies while maintaining the strong regulatory oversight and transparency that separate BDCs from other non-bank lenders in the marketplace. FS believes the “Small Business Credit Availability Act,” if enacted into law, would allow BDCs to more effectively fill the funding gap created as banks back away from the middle market, and thereby continue to support a key driver of economic 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 modestly raise the leverage limit for BDCs from the current 1:1 debt-to-equity ratio to just a 2:1 debt-to-equity ratio. FS strongly supports this proposed amendment because we believe it is a modest change that would allow BDCs to provide more capital to small and mid-sized U.S. companies in a responsible manner, while maintaining the transparency and investor protections that have made BDCs appealing investment options.

FS also believes that, relative to other lenders in the marketplace, a 2:1 debt-to-equity ratio remains conservative. Banks are currently levered in the high single digits to the mid-teens<sup>22</sup> and non-bank asset-based commercial lenders, private debt funds and hedge funds can employ as much leverage as the market will bear, far exceeding bank leverage ratios in many cases. In addition to these elevated levels of leverage, traditional banks, hedge funds and other non-bank lenders do not regularly disclose any specific details of their loan portfolios, providing far less transparency to investors than BDCs. We also note that Small Business Investment Companies, or “SBICs,” which are functionally and regulatorily close cousins of BDCs, have been operating safely and profitably at 2:1 leverage since 1958 and SBIC loans are backed by a federal government guarantee. Moreover, the U.S. Small Business Administration reported in January that, on average, the SBIC Program creates approximately one job for every \$16,000 invested.<sup>23</sup> Similar data is not available for BDCs, but assuming BDCs’ investment-to-job-creation ratio is similar to that of SBICs, the potential for job creation from this legislation is immense. BDCs are seeking to follow the proven leverage model of SBICs, with its proven job creation results, and with zero cost to taxpayers. It is with this backdrop that we see the proposal to allow BDCs to go to a 2:1 debt-to-equity ratio as a responsible, modest update to BDC regulation.

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 choose between two general investment strategies. The first strategy is to seek yield by investing deeper in the capital structure of a portfolio company. Such an approach creates more risk in the event the portfolio company experiences difficulty as there is less capital behind a BDC’s investment to absorb potential losses. The second strategy is to accept lower yields by investing higher in the capital structure of a portfolio company. This approach actually lessens inherent risk given the position of a BDC’s investment in the portfolio company’s capital structure, but also reduces returns to the BDC’s investors. An increase to the permissible debt-to-equity ratio would open up a third option. With slightly more leverage, BDCs could invest in assets higher in the capital structure that generate less yield, but apply the additional leverage to this strategy to compensate investors for the lower inherent risk and generate comparable returns. For all three of these reasons, FS supports this key element of the discussion draft currently before the subcommittee.

<sup>22</sup> 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 Board (“Fed”), the FDIC and the Office of the Comptroller of the Currency (“OCC”). See also, the FDIC Quarterly Banking Profile at <https://www.fdic.gov/bank/analytical/qbp/2017jun/qbp.pdf>.

<sup>23</sup> “Measuring the Role of the SBIC Program in Small Business Job Creation,” U.S. Small Business Administration, January 2017, available at: [https://www.sba.gov/sites/default/files/articles/SBA\\_SBIC\\_Jobs\\_Report.pdf](https://www.sba.gov/sites/default/files/articles/SBA_SBIC_Jobs_Report.pdf).

FS 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 practical change to the application of leverage limits. Additionally, we support the requirement that non-traded BDCs offer quarterly liquidity to all security holders as of the notice date of such board approval. We believe 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 addresses input we received through feedback from congressional members and the Commission.

FS believes certain elements about the application of the leverage provisions of the proposed legislation should be highlighted. First, we do not believe that every BDC would choose to, or 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 that BDCs will not move to the maximum allowable leverage of 2:1 because of a number of existing regulatory and market-driven constraints.

The first natural governor on leverage is the cushion 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, including the requirement to fair value investment assets on a quarterly basis 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.<sup>24</sup> FS 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.<sup>25</sup>

The second natural governor on leverage is the compliance regimes established by bank regulators. In order to access leverage, BDCs typically have bank partners that are willing and able to lend to them and 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 financial covenant requiring the maintenance of a 200% minimum asset coverage ratio.<sup>26</sup> 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.<sup>27</sup>

Yet another natural governor on the use of leverage by BDCs is the rating agencies. Rating agencies review the underlying portfolios of BDCs when assigning credit ratings. BDCs that invest in highly leveraged assets, most notably assets that are deeper into a portfolio company’s capital structure, while increasing their overall leverage ratios, will have a more difficult time maintaining an investment grade rating.<sup>28</sup> Needless to say, BDCs with poor (or no) 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

<sup>24</sup> The BDC Almanac – Episode III, Wells Fargo Equity Research, January 22, 2014.

<sup>25</sup> *Id.*; see also, Fitch Wire: “Leverage Limit Increase Could Differentiate BDC Ratings,” Fitch Ratings, January 7, 2014.

<sup>26</sup> *Id.*

<sup>27</sup> 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://www.fdic.gov/bank/analytical/qbp/2017jun/qbp.pdf>.

<sup>28</sup> *Id.*

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 consider a BDC's leverage levels to be inappropriate, and the demand for shares in that BDC declines, the BDC will likely have to de-lever to maintain a leverage ratio that is both compliant and more palatable to investors.

For all of these reasons, FS 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, maintain low leverage ratios relative to other lenders in the marketplace, and provide the opportunity to continue to generate returns to individual investors while lowering the inherent risk of a portfolio.

#### 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 previously 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. Moreover, these changes would streamline and reduce duplicative filings that must be reviewed by SEC staff, thereby increasing regulatory efficiency and freeing up regulatory resources for more productive purposes. Importantly, this change would not make BDCs any less transparent than they are today. This provision of the bill has broad support and FS is in favor of including it in the legislation.

#### Refinements to H.R. 3868 (114<sup>th</sup>)

The current discussion draft of the "Small Business Credit Availability Act" is notably shorter than its predecessor, H.R. 3868, introduced in the 114<sup>th</sup> Congress. In addition to the leverage and offering reform provisions discussed above, H.R. 3868 contained three other provisions that have been excised from the discussion draft. The excised provisions would have: (1) allowed BDCs to issue preferred stock; (2) allowed BDCs, under certain circumstances, to own securities issued by, and other interests in the business of, registered investment advisers; and, (3) expanded the definition of "eligible portfolio company" to permit BDCs to significantly increase exposure to investments in certain financial companies.<sup>29</sup> The BDC industry expressed concerns about a number of these provisions. Despite the inclusion of these provisions in H.R. 3868, FS and the BDC industry broadly were supportive of the leverage increase and offering reform provisions included in that bill, which was approved by the House Financial Services Committee in the previous Congress by a vote of 53-4, and are even more supportive of those two provisions standing alone as in the discussion draft.

#### 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. FS believes that middle market companies in particular will

<sup>29</sup> 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.

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 BDC's position in the marketplace as a highly regulated, transparent investment vehicle.

We thank Representative Stivers for his efforts in crafting this legislation and Representative Moore for her efforts to improve on previous drafts, as well as Chairman Huizenga and Ranking Member Maloney for their efforts to help modernize the BDC industry. FS and the SBIA and its members stand 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.



STATEMENT OF  
PATRICK J. McCOY

PRESIDENT, GOVERNMENT FINANCE OFFICERS ASSOCIATION

ON BEHALF OF THE GOVERNMENT FINANCE OFFICERS ASSOCIATION

LEGISLATIVE PROPOSALS TO IMPROVE SMALL BUSINESSES' AND COMMUNITIES'  
ACCESS TO CAPITAL

BEFORE THE  
HOUSE FINANCIAL SERVICES COMMITTEE  
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND INVESTMENTS  
UNITED STATES HOUSE OF REPRESENTATIVES

NOVEMBER 3, 2017

Chairman Huizenga, Ranking Member Maloney and distinguished members of the Capital Markets, Securities and Investment Subcommittee, thank you for holding today's hearing on legislative proposals to improve small businesses' and communities' access to capital. My name is Pat McCoy and I serve as the President of the Government Finance Officers Association (GFOA). My remarks here today are in my capacity as President of GFOA and not of the Metropolitan Transportation Authority in New York where I serve as the Director of Finance. GFOA represents over 19,000 public finance officers from State and local governments, schools and special districts throughout the United States. This includes about 2,500 Michigan and 1,500 New York national GFOA and state GFOA members.

GFOA is dedicated to the professional management of governmental financial resources by advancing fiscal strategies, policies and practices for the public benefit, including issues related to issuing tax exempt bonds and investing public funds. On behalf of the GFOA and its members, I appreciate the opportunity to provide comments at this hearing on H.R. 2319, the *Consumer Financial Choice and Capital Markets Protection Act of 2017*.

Specifically, I will describe how money market funds have been utilized effectively to both manage liquidity for public sector investments and provide a reliable source of working capital to fund public services and finance infrastructure investment and economic development. I will also describe the impact of the U.S. Security and Exchange Commission's (SEC) change of net-asset-value (NAV) accounting methodology for money market mutual funds (MMMMF) from stable to floating.

State and local governments access the capital markets and issue short term debt for a variety of reasons. This important legislation would allow governments to continue this access without increasing costs for taxpayers. I am particularly interested in these issues as a finance officer with a large and diverse portfolio of over \$38 billion of tax exempt bonds outstanding. Variable rate debt structured with hard puts has historically been a reliable low risk investment choice for money market funds and it has also been a very low cost method of financing as compared to issuing fixed-rate bonds. GFOA has published best practice guidance on the use of variable rate debt to ensure that it is used appropriately.

Overall, money market funds are a widely-used cash management tool for individuals as well as for state and local governments. According to Federal Reserve data<sup>1</sup>, state and local governments hold over \$183 billion of assets in money market funds. In addition, money market funds themselves are key purchasers of municipal securities – historically, they have

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<sup>1</sup> See <https://www.federalreserve.gov/releases/z1/current/z1.pdf>, page 84.



been the largest purchasers of short-term tax exempt debt. Therefore, the impact of the SEC rule on governments is real and it affects not only large governmental entities like mine, but also small communities throughout the country.

While we have supported and continue to support initiatives that both strengthen money market funds and ensure that investors are investing in high-quality securities, we applaud Representatives Rothfus, Stivers and Moore for introducing legislation which focuses on addressing the unintended consequences of the SEC's 2014 amendments to Rule 2a-7 that require institutional, non-government MMFs to price their shares at a floating net asset value (NAV), and to allow those funds to return to a fixed NAV.

The original objectives of the floating NAV rule were to protect investors in money market funds by preventing runs that hamper access to short-term capital, shield taxpayers from future financial bailouts, and promote general market stability. Those objectives were effectively addressed in the 2010 Amendments to Rule 2a-7. GFOA supported the amendments which dramatically increased the credit quality of the assets held in MMFs, required money market funds to have a minimum percentage of their assets in highly liquid securities so that those assets can be readily converted to cash to pay redeeming shareholders, and increased transparency by requiring funds to regularly calculate their "shadow prices" (i.e., their portfolios' per-share values at market prices).

Despite the success of the 2010 reforms, the SEC adopted additional amendments to Rule 2a-7 in July 2014. Among other things, those amendments require institutional prime and tax-exempt funds to use a floating NAV.

The SEC's reasoning was that a floating NAV would provide investors with a more frequent and accurate assessment of the value of a fund's assets. Under previous rules, institutional prime and tax-exempt MMFs were allowed to round their share price to \$1.00, so long as the actual value of a share does not fall below \$0.9950 ("break the buck"). The SEC's change from fixed to floating was predicated on the belief that investor awareness of the actual value of the fund's assets will make investors less likely to redeem shares in times of economic distress.

Throughout the rulemaking process, GFOA and public finance officers throughout the country submitted analysis showing that a floating NAV would do little to deter heavy redemptions during a financial crisis but would, instead, impose substantial costs on state and local governments. That is exactly what has come to fruition.

Between January 2016 and July 2017, tax exempt MMFs assets under management fell by 50 percent, from \$254 billion to \$135 billion<sup>2</sup>, dramatically shrinking an important market for municipal debt. At the same time, municipalities issuing variable rate demand bonds saw their borrowing costs nearly double the Federal Reserve's rate increases over the same period. Many state and local governments determined that issuing variable rate debt to MMFs was excessively costly, and opted to issue higher cost fixed-rate bonds. These increased costs are shouldered by taxpayers and ratepayers.

In addition to the impact that the SEC's 2014 actions had on governments accessing the capital markets, there are also implications for the investments that state and local governments use to protect public funds. Many governments have specific state or local statutes and policies that require them to invest in financial products with a stable NAV. The policy reason for this is to ensure that public funds are appropriately safeguarded. MMFs with a stable NAV are a commonly used vehicle by state and local governments for managing operating cash. This important legislation would lift an unnecessary obstacle that has steered state and local entities into very low yielding U.S. government backed funds or other alternatives from what was already a safe and highly liquid market.

By allowing all MMFs – prime, tax-exempt and government funds accessible to both retail and institutional investors – to offer a stable NAV, H.R. 2319 would allow state and local governments to once again utilize suitable investments defined by state and local elected officials, rather than by the SEC.

GFOA is working with a coalition of stakeholders to advance H.R. 2319 and we have submitted our most recent letter of support for the record. Thank you again for considering this important legislation. We look forward to working with you and supporting your efforts to help state and local governments on this and other regulatory and financial matters of mutual interest.

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<sup>2</sup> See: <https://www.federalreserve.gov/releases/efa/exempt-money-market-funds-investment-holdings.htm> Money Market Mutual Funds: Investment Holdings Detail, Figure 4



## Statement of the U.S. Chamber of Commerce

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**ON: Legislative Proposals to Improve Small Businesses'  
and Communities' Access to Capital**

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**TO: House Committee on Financial Services,  
Subcommittee on Capital Markets, Securities and  
Investment**

**BY: Thomas Quadman, Executive Vice President, Center  
for Capital Markets Competitiveness, U.S. Chamber of  
Commerce**

**DATE: November 3, 2017**

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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% 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.

Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee on Capital Markets, Securities, and Investment: My name is Tom Quaadman, executive vice president of the Center for Capital Markets Competitiveness (“CCMC”) at the U.S. Chamber of Commerce (“Chamber”).

The Chamber commends the continued work of both this subcommittee and the full Financial Services Committee to modernize our nation’s securities laws and create opportunities for American households, businesses and investors. Over the last seven years, the Financial Services Committee has advanced dozens of pieces of bipartisan legislation, many of which have been enacted into law. Most notably, the Jumpstart our Business Startups (“JOBS”) Act, signed by President Obama in April 2012, has successfully helped a number of business go public in addition to creating more ways for businesses to raise capital through private channels.

The 2008 financial crisis and the ad-hoc legislative and regulatory response that followed the crisis made clear that the financial regulatory system in the United States is badly out of date and in need of serious reform. Elements of our regulatory framework date as far back as the Civil War, and many agencies that were created in response to a particular historical event have struggled to meet the modern needs of an economy as dynamic as the United States. It is little wonder that instead of a strong rebound to the 2008-2009 financial crisis—which typically occurs after a severe financial downturn—our economy has meandered along between one and two percent growth over the last decade.

The time to pursue pro-growth policies is now. The historically weak recovery has left millions behind in our economy, exacerbated our national deficits and debt, and resulted in an alarmingly low number of business startups as compared to previous recoveries. While fundamental tax reform remains the Chamber’s top priority to spur growth and opportunity, we believe that Congress and regulatory agencies should pull every lever possible to modernize our regulatory systems for the 21<sup>st</sup> Century.

To put our economic potential into perspective, if the economy moved from 2% to 3% annual growth, that would mean doubling gross domestic product (GDP) per capita 12 years faster (23 years vs. 35 years); it would also reduce our annual deficit by over \$3 trillion over the next decade. If our economy went from 2.5% growth to 3% growth, average annual incomes would rise by \$4,200 and 1.2 million jobs would be created over the next decade. That is the top-level perspective, but underlying these macro statistics is the opportunity for millions of Americans to create a better life for themselves and their families.

It is also worth noting that not only has the post-crisis recovery been historically weak, it also been remarkably uneven from a geographic standpoint. An illuminating 2016 report from the Economic Innovation Group showed that while certain pockets of the country have rebounded economically, others continue to struggle. For example, 50% of the net national businesses created from 2010-2014 are located across only *twenty* counties in the United States, despite these counties only representing 17% of the U.S. population. Moreover, nearly three in five counties saw more businesses close than open from 2010 to 2014. The overall level of business creation is well below previous recovery levels: while the rebound from the recession of 2001-2002 saw 400,500 businesses created, the post-crisis number has only been 166,500.<sup>1</sup>

The Chamber believes that it is by no means a coincidence that these anemic economic numbers have coincided with a massive expansion of the regulatory state, particularly in the wake of the 2008 crisis. Modernization of our financial regulatory structure is sorely needed, and we appreciate this opportunity to have the voice of the Chamber's members heard in this important debate.

### 1. Modernizing our Financial Regulatory Structure

In September 2016, the Chamber released a reform plan entitled *Restarting the Growth Engine: A Plan to Reform America's Capital Markets (Restarting the Growth Engine Plan)*, which has over 100 recommendations for creating a regulatory system that embraces stability and growth. The Chamber was pleased to see that the Financial CHOICE Act approved by the Financial Services Committee during the 114<sup>th</sup> Congress included a number of the recommendations in the Restarting the Growth Engine Plan, including but not limited to:

- Structural and managerial reforms to the Securities and Exchange Commission (SEC), as well as streamlining SEC enforcement authorities to ensure fair treatment and due process during the course of investigations.
- Congressional oversight of the regulatory policy functions for all financial regulators through the appropriations process.
- Recognition that several provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including addressing arbitrary thresholds for regional and mid-size banks, capital, liquidity, and other requirements, are

<sup>1</sup> "The New Map of Economic Growth and Recovery" Economic Innovation Group, May 2016

creating a severe drag on the economy and damaging the health of the capital markets.

- Structural and authority modifications to the Financial Stability Oversight Council (FSOC), as well as greater transparency requirements for U.S. participants in Financial Stability Board (FSB) decisions and actions, as well as the actions of other international standard setters and regulators that report to the FSB.
- Repeal of the Volcker Rule, as it has created impediments for non-financial businesses to enter the debt and equity markets. The Volcker Rule has placed market participants operating in the U.S. at a global competitive disadvantage.
- Incorporation of several bills that passed this Committee or the full House of Representatives during the 114<sup>th</sup> Congress. These bills would help foster capital formation by expanding opportunities for investors and ensuring that regulators focus on the need of small and growing businesses.

The Chamber has been especially supportive of Title X of the CHOICE Act, which would modernize securities regulation in a manner similar to the JOBS Act. We would also note that there were several recommendations in the Restarting the Growth Engine Plan that were not included in the previous version of the CHOICE Act. As the Financial Services Committee continues its important work during the 115<sup>th</sup> Congress, we look forward to collaborating with you on many of these important issues.

## 2. Legislative Proposals

### a. Small Business Credit Availability Act (Discussion Draft)

One of the unfortunate developments in the wake of the financial crisis has been the difficulty for small and medium-sized businesses to obtain the capital and liquidity they need to grow and serve Main Street America. While large corporations often times face their own financing challenges, the obstacles that smaller firms face are particularly acute. Given the slow rate of business creation in the wake of the crisis, it is no exaggeration to say that the very survival of thousands of businesses depends on the ability of our capital market to serve them.

In 2016, the Chamber released a report, *Financing Growth: The Impact of Financial Regulation* (“Financing Growth Report”) which highlighted the financing challenges

faced by the middle market, and the need for businesses to have access to a variety of financing mechanisms. For example, 79% of the 300 professionals surveyed in the report have seen their business affected by changes in the financial services markets, and as a result nearly one-fifth of respondents had delayed or cancelled planned investments. And 20% of all small and midsize companies said they use four or more financial institutions to issue commercial paper, raise debt, or access trade financing.

Business development companies (“BDCs”) are a critical source of financing for small and middle market companies. BDCs offer a unique form of financing with certain attributes similar to private equity, venture capital, or hedge funds, but in a registered, highly-regulated and transparent investment vehicle. BDC lending has become increasingly popular as the credit cycle and regulatory reaction to the financial crisis have made accessing debt financing more challenging. Importantly, BDCs are actually mandated to invest 70% of their assets in small and medium-sized U.S. operating businesses.

Since their creation in the 1980’s BDCs have been highly regulated entities, where oversight can occur either at the regulatory level, or indirectly through the types of financing that BDCs are able to access in order to finance their investments. BDCs also tend to provide investors with a higher yield and, because they are publicly registered, are open to non-accredited investors. In fact, there are now 93 BDCs total with over 50 publicly traded in the United States, affording ample opportunities for investors to participate in the growth of middle market companies.

Investment vehicles such as BDCs are all the more important given the above-referenced geographic unevenness of the economic recovery. While credit has tightened and business creation has languished in some parts of the country, BDCs have made sizeable investments throughout the Rust Belt and other areas that have not enjoyed a strong recovery from the 2008 crisis. For example, BDCs have made investments of \$1.6 billion in Ohio, \$1.06 billion in Michigan, and \$1.8 billion in Tennessee.<sup>2</sup>

The Small Business Credit Availability Act would increase the capital available to BDCs and increase their ability to provide small and medium-sized businesses with the funding they need to grow. For example, the legislation would allow for a modest increase in the use of leverage available to BDCs which would ultimately permit them to deploy more capital to portfolio companies. Additionally, the legislation would allow some BDCs to be treated as “well-known seasoned issuers” under the securities laws which would allow them to issue securities more efficiently, and reduce some of

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<sup>2</sup> Small Business Investor Alliance BDC Modernization Agenda for the 115<sup>th</sup> Congress



the unnecessary cost burdens that are ultimately passed on to portfolio companies or investors.

Additionally, we believe that the Small Business Credit Availability Act also strikes an appropriate balance by allowing BDCs to expand without compromising investor protection. The SEC would maintain full oversight of BDCs to ensure that transparency, efficiency, and competition remain hallmarks of the market.

The Chamber strongly supports the Small Business Credit Availability Act and urges the Committee to take up the legislation as soon as possible.

#### **b. Expanding Investment Opportunities Act (Discussion Draft)**

The Chamber also supports the Expanding Investment Opportunities Act, which would allow certain qualifying closed-end funds to be eligible for status as a well-known seasoned issuer (WKSI) and therefore subject to a host of filing and proxy requirements that would allow them to operate more efficiently. For example, by allowing certain funds to achieve WKSI status, they would be eligible to use 'short form' registration statements, as well as communications mechanisms with their shareholders that they are currently prohibited from using.

At mid-year, closed end funds held over \$270 billion in assets,<sup>3</sup> providing an attractive investment option for investors and serving as an important liquidity provider for issuers of securities. But the SEC's rules regarding closed end funds have not kept pace with rules governing securities offerings by other public companies. Closed end funds were largely excluded from the SEC's 2005 securities offering reform initiative. This asymmetry has created an unnecessary and expensive regulatory burden for closed end funds, which must regularly petition the SEC and its staff for exemptive relief to permit such funds to engage in capital-raising activities that other public companies can do automatically without the need for special relief. We believe these additional regulatory hurdles also stifle capital formation in the closed end fund industry. CCMC supports the Expanding Investment Opportunities Act as a sensible response to this situation. We believe if enacted the bill would place closed end funds on even footing with other public companies and stimulate capital formation in that sector without harming investors.

#### **c. Consumer Financial Choice and Capital Markets Protection Act of 2017**

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<sup>3</sup> [https://www.ici.org/research/stats/closedend/cef\\_q2\\_17](https://www.ici.org/research/stats/closedend/cef_q2_17)

Main Street businesses rely on a variety of instruments to meet their short term financing and liquidity needs, including lines of credit from financial institutions as well as the U.S. commercial paper market. The nature of many businesses places a significant importance on obtaining short term financing—without it, orders may have to be cancelled, production could ground to a halt, and inventories could run low or become depleted. The importance of vibrant, competitive, and liquid short term financing markets for Main Street businesses cannot be overstated.

Regrettably, the post-crisis onslaught of dozens of new rules designed to strengthen the health of the financial system have in many cases made it more difficult for businesses of all sizes to obtain the short-term liquidity and financing that is so vital to their long-term health. These rules have included the Volcker Rule, the liquidity coverage ratio (LCR), net stable funding ratio (NSFR), as well as a host of other Basel capital rules that have made it more difficult for banks and other financial service providers to serve business. Indeed, 76% of respondents to the Chamber's Financing Growth Report believe that "the regulations on the financial services sector will not help their companies' outlook over the next two to three years."

This is why the Chamber has long called for the financial regulators to conduct a study of all major post-crisis regulatory initiatives in order to determine the full impact of these rules not just on the health of the banking system, but on the ability of nonfinancial companies to obtain credit. Fortunately, we are beginning to see recognition on behalf of regulators that these rules have come at a significant cost. The President's executive order earlier this year regarding core principles for regulating the U.S. financial system was a welcome start, as was the Office of the Comptroller of the Currency (OCC) announcement in August that it was beginning to conduct a review regarding the impact of the Volcker Rule.

One significant post-crisis regulatory development was adoption by the SEC of new rules for money market funds that went into effect on October 14, 2016. Along with corporate treasurers and many other market participants, the Chamber expressed significant concerns during the rulemaking process that the new rules would significantly impact the ability of corporate treasurers to manage liquidity and to raise cash in the commercial paper market. Specifically, we believed that the requirement for prime money market funds to float their net asset value ("NAV") and have it reported to the nearest hundredth of a cent would significantly hamper investments in such funds and also make recordkeeping much more complicated. Additionally, the imposition of liquidity fee and redemption "gate" provisions in the rules have also created significant deterrents for institutional investors to participate in institutional prime funds, as these provisions could limit liquidity during times of market stress and create the potential for loss of principal.

As the Chamber testified at a hearing of this subcommittee last year, during the 12 months prior to the October 2016 implementation date, prime fund purchases of corporate commercial paper declined significantly, while a number of institutional prime funds have also closed during the same time period. This has created further pressure upon corporate treasurers and businesses that have historically relied upon the liquidity provided prime institutional money market funds. A recent Treasury Strategies report stated that prime money market funding for businesses dropped from \$460 billion to \$88 billion from 2015 to 2017. This has caused a shift to bank funding which leads to smaller businesses getting crowded out of bank lending.

As with any major regulation, the Chamber strongly believes that agencies should first identify the problem, limit unintended consequences and address a specific issue in a targeted manner. We have advocated for regulators to review regulations after a certain period of time to determine if the problem is being addressed and to identify and correct unintended consequences.

We also appreciate legislative efforts such as H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act of 2017, which highlights an issue of importance to the funding of businesses. We look forward to working with this subcommittee to address these issues.

#### **Additional Efforts to Spur Capital Formation**

The Chamber believes that the Committee should look at additional ways to build upon the success of the JOBS Act and help more companies access the capital markets. While the JOBS Act was a positive step forward, in some ways it is not reaching its full potential. For example, as the Chamber pointed out in testimony earlier this year, the “Regulation A+” market (created by Title IV of the JOBS Act) has not taken off in the manner that Congress envisioned, and many deals still lack underwriters. Reg A+ offering compliance has proven to be costly relative to the amount of securities allowed under the current exemption. Congress should consider increasing the current \$50 million threshold in order to incentivize more market participants to use this valuable exemption.

Additionally, while the JOBS Act did a great deal to ease the burdens related to the offering of securities, it did relatively little to address secondary market trading issues for small public companies. In order to create a competitive and liquid trading environment for these companies, Congress should look at creating the legal framework to allow for “venture exchanges,” based on legislation from H.R. 4868 in the 114<sup>th</sup> Congress, the “Main Street Growth Act.” We believe that creating venture

exchanges and allowing issuers to choose where they want to list would provide a positive alternative to today's market structure that often times favors large, liquidly traded companies over smaller ones.

**Looking Forward**

We appreciate the work of the Capital Markets, Securities and Investment subcommittee on these important bills and issues. The Chamber is prepared to work with the subcommittee on a bi-partisan basis to achieve the reforms necessary to help American businesses and their customers.



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STATEMENT

OF

PAUL SCHOTT STEVENS  
PRESIDENT & CEO  
INVESTMENT COMPANY INSTITUTE

BEFORE THE

US HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND INVESTMENT

ON

**LEGISLATIVE PROPOSALS TO IMPROVE SMALL BUSINESSES' AND COMMUNITIES'  
ACCESS TO CAPITAL**

NOVEMBER 3, 2017

## EXECUTIVE SUMMARY

## Closed-End Fund Legislation

- ICI fully supports Representative Hollingsworth's discussion draft of the "Expanding Investment Opportunities Act." The legislation would modernize the offering and proxy rules for closed-end funds, enabling them to utilize already existing offering and communications rules that traditional operating companies have relied on since 2005.
- By simplifying the closed-end fund offering process and liberalizing existing restrictions on communications, the legislation would reduce unnecessary regulatory burdens that raise costs for investors. In turn, this would enhance the ability of closed-end funds to act as a source of financing in the economy.
- Specifically, the legislation would require the Securities and Exchange Commission ("SEC") to amend its rules within one calendar year to provide several technical, but tangible, benefits to closed-end funds and their shareholders:
  - Closed-end funds that meet the criteria of a "well-known seasoned issuer" (having at least \$700 million common equity outstanding and having timely made required filings for the preceding 12 calendar months) could register and offer additional shares more quickly through the "automatic shelf registration" process to take advantage of current market conditions.
  - Closed-end funds that meet the criteria of a "seasoned issuer" (having at least \$75 million in common equity outstanding and having timely made required filings for the preceding 12 calendar months) could incorporate information from subsequent filings into their registration statements automatically.
  - Closed-end funds that meet the conditions of several existing safe harbors could rely on those safe harbors to communicate with investors and potential investors more freely during a registered offering.
  - Closed-end funds and, ultimately, their shareholders could save on the costs of prospectus delivery under certain conditions.

#### Business Development Company Legislation

- Congress created business development companies (“BDCs”) as a specialized type of closed-end fund whose principal activities consist of investing in, and offering to provide “significant managerial assistance” to, small, growing, or financially troubled operating companies. BDCs are regulated under the Investment Company Act of 1940, but Congress provided BDCs with greater operating flexibility than other closed-end funds or mutual funds.
- Congress already has granted BDCs more flexibility to utilize leverage than other registered investment companies. Consistent with that approach, the BDC legislative proposal would lower the asset coverage requirement for senior securities, *i.e.*, debt and preferred stock, to 150 percent from 200 percent. We do not object to this change.
- ICI supports the proposed offering and communications reforms for BDCs for the same reasons ICI supports the proposed offering and communications reforms for closed-end funds.

#### Money Market Fund Legislation

- The Securities and Exchange Commission has modernized and strengthened the regulatory requirements for money market funds from time to time as circumstances have warranted—most recently in 2010 and 2014 in response to the 2008 financial crisis.
- The 2010 and 2014 SEC reforms add layers of transparency and redundant safeguards that more than adequately address any risks that may have existed in 2008.
- The Consumer Financial Choice and Capital Markets Protection Act of 2017 (“H.R. 2319”) would rescind many of the 2014 reforms including the requirement that prime institutional and tax-exempt institutional money market funds float their NAVs. Although some ICI members have expressed strong interest and support for the bill, other members believe that a third round of regulatory changes to money market funds is neither appropriate nor desirable.
- As a result of these strongly differing member views regarding H.R. 2319, ICI takes no position on the proposed legislation.

Statement of Paul Schott Stevens

I. Introduction

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute (“ICI”), the leading association representing regulated funds globally, including mutual funds, exchange-traded funds, closed-end funds, and unit investment trusts in the United States (“registered funds”), and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI’s members manage total assets of US\$20.9 trillion in the United States, serving more than 100 million US shareholders, and US\$6.6 trillion in assets in other jurisdictions. Thank you, Chairman Huizenga, Ranking Member Maloney, and members of the Subcommittee for inviting me to testify on “Legislative Proposals to Improve Small Businesses’ and Communities’ Access to Capital.”

In addition to serving as the vehicles through which more than 100 million Americans save for retirement or pursue other important financial goals, registered funds play an important role in the US economy. They channel capital from fund investors to the markets which, in turn, stimulates economic growth and job creation. The injection of capital through fund investments benefits underlying businesses that rely on the markets as an important source of financing. The underlying businesses utilize the capital to hire employees, fund their enterprises, and develop new technologies, sparking continued innovation and growth.

My testimony focuses on Mr. Hollingsworth’s discussion draft of the “Expanding Investment Opportunities Act,” legislation that would modernize the offering and proxy rules for one type of registered fund—closed-end funds (“Discussion Draft”). Notwithstanding the benefits these funds provide to investors and the capital markets, the last several years have seen a steady decline in the number of closed-end funds and new closed-end fund offerings. By simplifying the closed-end fund offering process and liberalizing existing restrictions on communications with investors before and during an offering, the legislation would reduce unnecessary regulatory burdens that raise costs for investors. These changes, which would conform closed-end fund offering rules to those for traditional operating companies, could encourage new closed-end fund offerings and lead to a concomitant increase in the long-term capital these funds supply to companies in which they invest. For these reasons, ICI strongly supports this legislation.

In the sections that follow, I first provide background information on closed-end funds and their comprehensive regulatory framework (Section II). I then describe how the Discussion Draft would change the current requirements for closed-end fund offerings and communications, and explain the benefits of these changes for closed-end funds and their shareholders and, by extension, capital formation (Section III). I conclude with brief comments on pending legislative proposals concerning business development companies and money market funds (Section IV).



## II. Background on Registered Closed-End Funds

To provide context for ICI's views, it is important to understand what closed-end funds are and how they are regulated.

A closed-end fund, like other types of investment companies, is a pooled investment vehicle that is **professionally managed in accordance with the fund's investment objectives and policies**. Generally, a closed-end fund is created by issuing a fixed number of common shares to investors during an initial public offering. Subsequent issuances of common shares can occur through secondary or follow-on offerings. A closed-end fund may raise additional capital by issuing debt securities and one class of preferred stock in addition to common shares. The holders of the common stock experience a gain or loss depending on whether the fund earns a rate of return on its assets that is higher or lower than the amounts that it pays to the holders of its debt securities and preferred stock.

After a fund's initial public offering, investors generally buy and sell shares of a closed-end fund in the open market (typically on a securities exchange such as the New York Stock Exchange), rather than directly from or to the fund. Some closed-end funds, however, may adopt share repurchase programs or periodically make tender offers for shares. The market price of a closed-end fund share fluctuates like that of other publicly traded securities and is determined by supply and demand in the marketplace. In contrast to a mutual fund, which must stand ready to meet shareholder redemptions on a daily basis and therefore must invest mostly in liquid assets, a closed-end fund has the flexibility to invest a significant percentage of its assets in less liquid securities. For example, a closed-end fund may invest in securities issued by small private companies and long-term tax-free investments.

The flexibility that closed-end funds have to invest in these types of assets and to issue debt securities and preferred stock allows closed-end funds to:

- provide enhanced income and cash flow (through investments in longer term or less liquid higher yielding assets);
- maximize after-tax efficiency (through investments in certain tax-free investments); and
- broaden diversification (through investments in specialized asset classes).

Registered closed-end funds are comprehensively regulated under the federal securities laws and related Securities and Exchange Commission ("SEC") regulations, which serve to protect the interests of fund investors. Closed-end funds, like publicly traded operating companies, are subject to the Securities Act of 1933 ("1933 Act"), which governs the way public offerings are conducted. Closed-end funds file registration statements with the SEC on Form N-2 to register the offering of their securities under the 1933 Act and to register as investment companies under the Investment Company Act of 1940

(“Investment Company Act”). The Form N-2 contains three parts, including a prospectus, which includes required disclosures about the fund.

In addition, closed-end funds are subject to regulation under the Securities Exchange Act of 1934 (“Exchange Act”). Like most publicly traded operating companies, closed-end funds file annual and semi-annual reports as well as quarterly reports.<sup>1</sup> Each of these periodic reports includes certifications from the principal executive officer and the principal financial officer. Like operating companies, closed-end funds also are subject to the proxy and tender offer provisions of the Exchange Act.

In contrast to publicly traded operating companies, closed-end funds are subject to further substantive regulation under the Investment Company Act. The Investment Company Act restricts, among other things, a closed-end fund’s ability to use leverage, offer new shares below net asset value, engage in affiliated transactions, and imposes strict requirements on the custody, diversification (for a diversified closed-end fund) and transparency of fund assets. The Investment Company Act also requires a registered closed-end fund to have a board of directors with a specified proportion of directors that are independent of the fund’s manager.<sup>2</sup> In addition, it requires registered closed-end funds to have a chief compliance officer who oversees the day-to-day operations of the fund under a board-approved fund compliance program and policies.

With their ability to provide enhanced income and cash flow, closed-end funds serve as an important retirement savings and investment vehicle for retail investors. As of June 2017, there were 533 closed-end funds with total assets of \$271 billion. We estimate that approximately 3 million retail investors rely on closed-end funds to help meet their investment needs.

### III. Importance of the Closed-End Fund Discussion Draft

Despite their numerous benefits, the number of closed-end funds has declined steadily over the last several years. Since 2007, the number of closed-end funds has dropped 19 percent (from 662 funds at year-end 2007 to 533 funds in June 2017). In addition, the number of new closed-end fund offerings has dropped. In 2007, there were 42 new closed-end fund issuances; in 2016, there were only eight.<sup>3</sup> That is an 81 percent decline.

The Discussion Draft would help reverse these trends by reducing the burdens of certain requirements under current SEC registration and communications regulations that apply to closed-end funds. Existing requirements impose substantial costs on closed-end funds and their shareholders without commensurate investor protection benefits. Closed-end funds offer and sell their shares in the same

<sup>1</sup> Closed-end funds file annual and semi-annual shareholder reports on Form N-CSR and file quarterly reports on Form N-Q. Operating companies make periodic filings on Form 10-K and Form 10-Q.

<sup>2</sup> In practice, most boards have 75 percent or more independent members.

<sup>3</sup> This is based on the last full year of data. See Antoniewicz, Rochelle, and Julieth Saenz. 2016. “The Closed-End Fund Market, 2016” ICI Research Perspective 23, no. 2 (April) at Figure 7.

manner as securities issued by traditional operating companies, yet their offer and sale are subject to additional requirements. The Discussion Draft would cure this unjustified regulatory disparity by applying the same rules to closed-end funds and operating companies. To take advantage of the additional flexibility provided by the rules, a closed-end fund would have to meet the same conditions of the rule that operating companies must meet. Those requirements would apply *in addition to* the extensive investor protection provisions of the Investment Company Act and other federal securities laws.

In 2013, when former SEC Chair Mary Jo White evaluated legislative proposals nearly identical to the Discussion Draft that would put business development companies, one form of closed-end fund, on par with other operating companies for both offerings and communications, she noted that “[i]n my view, these provisions do not raise significant investor protection concerns.”<sup>4</sup> We wholeheartedly agree that these offering and communications reforms do not raise significant investor protection concerns. We therefore believe that now is the time for Congress to act to modernize the regulatory framework for closed-end fund offerings and communications.

The Discussion Draft addresses the current, unsatisfactory situation. It directs the SEC, within one year of the legislation’s enactment, to amend certain rules and registration forms to permit closed-end funds to operate under the streamlined registration process—and additional flexibility around public communications—that operating companies have been able to take advantage of for more than a decade. The cost savings associated with these changes would be passed on to fund shareholders, making these important investment vehicles more attractive than they are today.

The section of my testimony below begins with a description of the closed-end fund registration process and how the Discussion Draft would simplify it. It then describes how closed-end funds currently communicate with the public about their offerings and how the Discussion Draft would encourage them to provide even more information. Finally, it concludes with a brief discussion responding to potential concerns that the Discussion Draft raises.

#### A. Current Registration Process for Closed-End Funds

As mentioned above, a closed-end fund generally is created by issuing a fixed number of common shares to investors during an initial public offering. Depending on market conditions, a registered closed-end fund after its initial public offering might determine that it is an opportune time to invest more assets into the market. In these circumstances, certain closed-end funds can utilize a streamlined process known as “shelf registration,” which involves filing a “shelf registration statement” with the SEC to register and publicly offer additional securities to raise additional capital for investment.<sup>5</sup>

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<sup>4</sup> See Letter from Mary Jo White, Chair, Securities and Exchange Commission, to The Honorable Jeb Hensarling, Chairman, Financial Services Committee, US House of Representatives, dated October 21, 2013 (providing the Chair’s views on substantially identical business development company legislation).

<sup>5</sup> Rule 415 under the 1933 Act permits issuers to utilize shelf registration statements. Although Rule 415 does not expressly extend to closed-end funds because the Rule only applies to Form S-3 and not Form N-2, two SEC staff no-action letters

To use a shelf registration statement, the closed-end fund must meet the criteria of a “seasoned issuer,” which essentially requires that the closed-end fund have at least \$75 million in common equity outstanding and have made timely periodic filings with the SEC for the preceding 12 calendar months. Assuming the fund meets such criteria, the closed-end fund can offer additional shares to the public by filing a new shelf registration statement on Form N-2 to register the shares. Once the SEC staff declares the registration statement effective, the closed-end fund then can sell shares from the shelf registration statement as market conditions dictate for a period of up to three years. During this three-year period, the closed-end fund must make additional post-effective amendment filings to the shelf registration statement to include updated financial statements, to the extent necessary so that the incorporated financial statements are never more than 16 months old.<sup>6</sup>

This offering process has its drawbacks. First, the closed-end fund must wait for the SEC staff to declare the shelf registration statement effective before the fund can sell any additional shares. It can take several months for the SEC staff to provide comments, if any, on the registration statement, for the closed-end fund to respond to them, and for the SEC staff to declare the registration statement effective. The time this entire process takes can affect the timing and success of an offering.

Second, the process of filing a post-effective amendment to the shelf registration statement to incorporate a fund’s updated financial statements into the registration statement could cause issues if the SEC staff review is not completed and the post-effective amendment is not declared effective by the time the financial statements become “stale” (*i.e.*, are more than 16 months old).<sup>7</sup>

Many traditional operating companies do not face these issues. In 2005, the SEC adopted rules that significantly modernized the registration, communications and offering processes for them.<sup>8</sup> These reforms have been extremely successful as evidenced by the many operating companies that rely on them. The 2005 SEC Rule permits traditional operating companies that qualify as “well-known seasoned issuers,” or “WKSI,” to utilize an automatic shelf registration process. As their name suggests, automatic shelf registrations become effective automatically without SEC staff review and comment.

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permit closed-end funds meeting required conditions to rely on the rule using Form N-2. See Nuveen Virginia Premium Income Municipal Fund (pub. avail. Oct. 6, 2006); Pilgrim America Prime Rate Trust (pub. avail. May 1, 1998).

<sup>6</sup> “Incorporation by reference” is the act of including an additional document within another document by referencing the additional document. Issuers utilize incorporation by reference to include the substance of previous and future filings in a registration statement without attaching those filings as part of the registration statement.

<sup>7</sup> This stands in sharp contrast to the treatment afforded to open-end funds and closed-end interval funds. Open-end funds may rely on Rule 485 under the 1933 Act, which provides that a post-effective amendment filing shall become effective immediately if the amendment is filed solely to update financial statements, among other things. Closed-end interval funds may rely on Rule 486 under the 1933 Act, which provides similar eligibility for immediate effectiveness. A closed-end interval fund is a closed-end fund that, pursuant to Rule 23c-3 under the Investment Company Act, periodically offers to repurchase shares from its shareholders.

<sup>8</sup> See *Securities Offering Reform*, SEC Release No. 33-8591 (July 19, 2005), 70 Fed. Reg. 44722 (Aug. 3, 2005) (“2005 SEC Rule”), available at <https://www.sec.gov/rules/final/33-8591fr.pdf>.

To qualify as a WKSI, generally an issuer must have at least \$700 million in common equity outstanding and have timely filed required reports for the preceding 12 calendar months. In addition, the issuer within the past three years must not have engaged in conduct, or be subject to a conviction, decree, or order, that would make it ineligible.<sup>9</sup>

The 2005 SEC Rule also permits operating companies that qualify as “seasoned issuers” (generally, issuers that have at least \$75 million in common equity outstanding and have timely filed required reports for the preceding 12 calendar months) to utilize a technique known as “forward incorporation by reference.” This means that such issuers can incorporate information from future filings into a registration statement without having to amend the registration statement to reference the specific filing from which the information will be derived.

The 2005 SEC Rule, however, excluded registered closed-end funds from the reforms. Instead, the SEC indicated that the parallel regulatory framework for registered investment companies also should be updated. A dozen years later, no similar reforms ever have been proposed. Nor is there any prospect that they will be proposed in the future, considering the SEC’s crowded rulemaking agenda.

Although the frameworks governing operating company filings and closed-end fund filings may be separate, as described earlier, in substance they are substantially the same. We strongly support the Discussion Draft, because it would allow closed-end funds and their shareholders to benefit from the same cost saving reforms that operating companies have enjoyed for more than 12 years, and potentially spark additional closed-end fund offerings that would contribute to capital formation.

#### B. Reforms to the Registration Process

The Discussion Draft would address the drawbacks of the current registration process by reforming closed-end fund offerings in two respects. First, closed-end funds would be able to utilize “automatic shelf registrations” to offer additional shares if they qualify as “well-known seasoned issuers,” or “WKSIs.” As of December 2016, we estimate that there were 93 closed-end funds that could qualify as WKSIs. This is approximately 18 percent of all closed-end funds (93/530 total closed-end funds). Giving qualifying closed-end funds the ability to use this process would help those funds better evaluate and assess the market for their offerings. It would enable them more readily to access the capital markets without facing the risk of a delay that could suspend or terminate the offering.

Second, closed-end funds that qualify as “seasoned issuers” would be permitted to “forward incorporate by reference” information into their registration statements. As of December 2016, we estimate that there were 473 closed-end funds that could qualify as seasoned issuers. This is approximately 89 percent of all closed-end funds (473/530 total closed-end funds). As a result, closed-end funds would not need to file a post-effective amendment simply to amend their existing registration statement to include

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<sup>9</sup> An issuer would be ineligible, for example, if within the past three years it filed a bankruptcy petition or had an involuntary bankruptcy petition filed against it, was convicted of a felony or certain misdemeanors, entered into a judicial or governmental decree relating to certain violations of law, or was subject to an SEC stop order.

updated financial statements. Permitting closed-end funds to incorporate by reference in this manner would save time and money by eliminating unnecessary filings and associated costs.

By way of illustration, consider the contrast between the registration process for additional shares currently applicable to a hypothetical large, seasoned closed-end fund with an active shelf registration statement, on the one hand, and that of an operating company of similar size and experience, on the other. Assume that both companies have a public equity float of at least \$700 million and have made timely filings with the SEC for the past year. The fiscal year for both companies ends on December 31. Neither company has engaged in conduct within the past three years that would make it ineligible to rely on certain rules.

To use a shelf registration statement for the sale of securities, the audited financial statements therein must not be more than 16 months old. Accordingly, for the closed-end fund, the fund's lawyers must draft a full registration statement as a post-effective amendment to the shelf registration, file the same, await SEC staff comments, and resolve them. This process could entail multiple filings. Then, the SEC staff must declare the post-effective amendment effective, and do so before the 16-month period expires in order for the fund to be able to sell securities registered on the shelf without interruption. This process entails not only substantial delays, but also legal and audit fees. The fund's attorneys, for example, may charge fees for preparing each post-effective amendment and responding to SEC staff comments. Each time the audited financial statements near the end of their 16-month lifespan, the closed-end fund repeats the process.

In contrast, an operating company does not have to file a post-effective amendment to its registration statement because it simply files its annual report with the SEC, as the law requires, and the financial statements therein are automatically incorporated by reference in the shelf registration statement. There are no additional legal or audit fees associated with a filing, and there is no additional time that is spent for the review process.

Set forth in Appendix A is a more detailed, technical explanation of the registration process amendments the Discussion Draft would require the SEC to make to current rules under the 1933 Act, the proxy rules, Regulation FD, and Form N-2 under the Investment Company Act.

### C. Current Communications Process for Closed-End Funds

The federal securities laws regulate public securities offerings and impose certain requirements upon the "offer" of a security. The term "offer" is interpreted broadly and covers several types of communications regarding the security. There are very specific requirements as to what information can be communicated prior to the filing of a registration statement, during the period between the filing of the registration statement and its effective date, and after its effective date. Generally, when a security is publicly offered, the issuer of the security must provide required disclosures about the security to investors in the form of a full or "statutory" prospectus. Given the broad interpretation of the term "offer," the federal securities laws provide several exceptions to the statutory prospectus requirements when the issuer or others make public communications about the security. Many of these exceptions

take the form of “safe harbors” under which a company, upon meeting certain conditions, can provide information without having to deliver a statutory prospectus.

A closed-end fund primarily relies on Rule 482 under the 1933 Act to provide a broad range of communications without having to deliver the statutory prospectus. Rule 482 does not impose any limits on the types of information that may be included in the communication but, in certain instances, does require specific legends and, when performance advertising is included, does require certain disclosures. A closed-end fund may rely on Rule 482 only after it files a registration statement and must file all Rule 482 communications with the SEC or FINRA. For purposes of the federal securities laws, a Rule 482 communication is a prospectus, but it is deemed to be an “omitting” prospectus because it does not include all information a statutory prospectus must contain.

Absent a safe harbor or similar exception, Section 5(b)(2) of the 1933 Act requires a closed-end fund that sells its securities during an offering to provide a purchasing investor with its statutory prospectus.

#### D. Reforms to the Communications Process

The Discussion Draft would provide a closed-end fund with greater flexibility regarding its public communications. By making available to closed-end funds these additional safe harbors that operating companies have relied on for years, the legislation could reduce the number of Rule 482 filings a closed-end fund is required to make (and the attendant costs), reduce liability risk, and facilitate the issuance of communications during the period prior to filing a registration statement. The safe harbors also would provide legal protections to broker-dealers when issuing research reports on the closed-end fund. Finally, the safe harbors would allow a closed-end fund and ultimately, its shareholders, to save on the costs of prospectus delivery under certain conditions.

Together these reforms would facilitate greater availability of information to investors and the market and eliminate barriers to communications that have been made increasingly outmoded by technological advances. Providing investors and the market with more information could make closed-end fund offerings more attractive and spur additional investments. Eliminating these barriers also could reduce expenses for closed-end funds and their shareholders, again spurring additional interest.

A more detailed description of the communications safe harbors under the 1933 Act that would become available to closed-end funds under the Discussion Draft is included in Appendix B.

#### E. Response to Potential Concerns

As noted above, former SEC Chair White weighed in on earlier legislative proposals nearly identical to the Discussion Draft (but pertaining to business development companies). She concluded that the provisions “do not raise significant investor protection concerns.” Nonetheless, we understand that possible concerns have been raised regarding the Discussion Draft. Closer examination indicates that none is well placed.

The first concern is that closed-end funds that utilize automatic shelf registrations could register new offerings without a full SEC staff review. While this is true, similar treatment for operating companies appears to have worked well for over a decade. Moreover, all closed-end funds that would utilize these provisions already will have filed a registration statement that the SEC staff has reviewed and declared effective. Under the Investment Company Act, any change to an investment policy that a fund has designated as fundamental would require shareholder approval, so the fund could not unilaterally change such policies. In addition, the Sarbanes-Oxley Act of 2002 requires the SEC staff to review each reporting company at least once every three years, though the SEC staff review a significant number of companies more frequently. The SEC staff routinely comments on previously made filings and, at times, requires registrants to amend their filings in response to such reviews. The SEC staff also can issue stop orders to halt any ongoing offering. Finally, closed-end funds—like all other issuers—continue to be subject to the antifraud provisions of the securities laws. The SEC can bring actions against issuers for any false or misleading statements or omissions in the registration statement.

We understand that the question of SEC staff review may relate more specifically to closed-end funds that are not traded on a public exchange and invest in very specialized, less liquid assets (e.g., funds of hedge funds).<sup>10</sup> In this regard, the SEC staff already has implemented its own set of restrictions, requiring that registered closed-end funds that are funds of hedge funds only sell their shares to “accredited investors” and in minimum initial amounts of no less than \$25,000. Accredited investors are investors who earned income that exceeded \$200,000 (or \$300,000 with a spouse) in each of the prior two years and reasonably expect the same for the current year or have a net worth of over \$1 million either with or without a spouse (excluding the value of the person’s primary residence). According to the SEC, the category 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 [1933 Act’s] registration process unnecessary.”<sup>11</sup> Nothing in the Discussion Draft would change the SEC staff-imposed accredited investor requirement (or minimum initial investment), and we believe that, under these circumstances, those investors do not need the protections of a further SEC staff review. Moreover, as discussed above, to be eligible to utilize an automatic shelf registration, any non-exchange-traded closed-end fund would need to meet the WKSJ qualifications.<sup>12</sup>

The second concern involves whether the one-year period that the Discussion Draft affords the SEC to amend the rules is a sufficient timeframe in which to propose and adopt changes. If new rules are not adopted within that period, then a closed-end fund shall be entitled to treat the changes as having been completed. We understand that one year is a tight rulemaking timeframe, but believe that such a

<sup>10</sup> Closed-end interval funds typically are not exchange traded, but they do not appear to be the subject of concern. These funds operate pursuant to Rule 23c-3 under the Investment Company Act.

<sup>11</sup> See *Regulation D Revisions; Exemption for Certain Employee Benefit Plans*, SEC Release No. 33-6683 (Jan. 16, 1987), 52 Fed. Reg. 3015.

<sup>12</sup> With respect to any other type of non-exchange-traded closed-end fund (other than an interval fund or a fund of hedge funds), we have not identified any such fund that would meet the WKSJ qualifications.



requirement is necessary and appropriate in the circumstances. When it adopted the 2005 SEC Rule, the SEC expressed the view that, because closed-end funds and other registered investment companies are subject to a separate framework governing communications with investors, “it would be more appropriate to consider investment company issues in the context of a broader reconsideration of this separate framework.”<sup>13</sup> Since the 2005 SEC Rule was adopted, the SEC has had more than 12 years to consider a parallel framework for closed-end funds, but has not done so. We appreciate that the SEC constantly must determine how to allocate its limited resources among numerous competing (and changing) priorities. This unavoidable reality may well explain why the SEC has not yet returned to this matter. But it also suggests the odds are that the agency never will do so—absent direction from Congress and a time limit such as that prescribed in the Discussion Draft. It is for this reason that we support Congressional direction in this area.

#### IV. Proposals on Business Development Companies and Money Market Funds

##### A. Business Development Companies

Congress created BDCs as a specialized type of closed-end fund whose principal activities consist of investing in, and providing “significant managerial assistance” to, small, growing, or financially troubled domestic businesses. As originally conceived, Congress intended for BDCs to be publicly offered venture capital funds and to stimulate small business growth through their capital investments and “significant managerial assistance.” BDCs have grown in popularity since their creation in 1980 and through their growth have provided needed financing and support to small and mid-sized businesses, which can use this financing to fund job creation and new capital projects that boost economic growth.

Like other closed-end funds, BDCs are subject to substantial regulation under the federal securities laws. The primary regulations, under the Investment Company Act, require BDCs to provide “significant managerial assistance,” which involves providing guidance and counsel about the management, operations, or business objectives and policies of their portfolio companies or exercising a controlling influence over the management of policies of portfolio companies.<sup>14</sup> Congress did not intend BDCs to be passive investment vehicles like mutual funds. The Investment Company Act accordingly requires a BDC to invest at least 70 percent of its portfolio assets in cash (or high quality, short-term debt securities), securities issued by financially troubled businesses, or certain securities issued by “eligible portfolio companies” (generally, small private companies).

Given their specialized investment focus, Congress provided BDCs with greater operating flexibility than other closed-end funds or mutual funds. BDCs are subject to portions of the Investment Company Act and are not required to register as investment companies. The Investment Company Act does, however, impose the same restrictions on their custody of assets as other investment companies

<sup>13</sup> 2005 SEC Rule, *supra* note 8, 70 Fed. Reg. at 44735.

<sup>14</sup> In addition, BDCs are subject to the reporting requirements under the Exchange Act and therefore must file annual and quarterly reporting requirements.

and imposes different but significant restrictions on a BDC's transactions with affiliates, among other things. The Investment Company Act also requires that a majority of the BDC's directors or general partners be independent of the BDC's manager. Congress did, however, permit BDCs to incur greater leverage than other types of investment companies.<sup>15</sup>

Congress already has granted BDCs more flexibility to utilize leverage than other registered investment companies. Consistent with that approach, the BDC legislative proposal would lower the asset coverage requirement for senior securities, *i.e.*, debt and preferred stock, to 150 percent from 200 percent. We do not object to this change.

The BDC legislative proposal also includes provisions that would enable business development companies to rely on the same offering and communications reforms that we support for closed-end funds. Because business development companies are one form of closed-end fund that would be required to meet identical criteria or conditions of the reforms before utilizing them, we support the proposal for the same reasons we support the proposal for closed-end funds generally.

#### B. Money Market Funds

Since the early 1970s, money market funds have been a steady, predictable mainstay of finance. Today, over 54 million retail investors, as well as corporations, municipalities, and other institutional investors, entrust some \$2.7 trillion to money market funds as low-cost, efficient cash management tools that provide a high degree of liquidity, stability of principal value, and a market-based yield. Money market funds also serve as an important source of direct financing for state and local governments, businesses, and financial institutions, and of indirect financing for households. Without these funds, financing for all of these institutions and individuals would be more expensive and less efficient.

Money market funds owe their success, in large part, to the stringent regulatory requirements to which they are subject under the federal securities laws—including, most notably, Rule 2a-7 under the Investment Company Act. The regulatory regime under Rule 2a-7 has proven to be effective in protecting investors' interests and in sustaining their confidence in money market funds as a valuable tool for managing cash. The SEC has modernized and strengthened the rule from time to time as circumstances have warranted (most recently in 2010 and 2014, as discussed below).

In light of money market funds' experience in the financial crisis, and with the industry's strong support, the SEC in 2010 approved far-reaching rule amendments that enhanced an already-strict regime of money market fund regulation.<sup>16</sup> The amended rules made money market funds more

<sup>15</sup> The Investment Company Act requires that BDCs retain 200 percent asset coverage for senior securities (*i.e.*, debt securities and preferred stock). For other closed-end funds, the asset coverage requirement is 300 percent for debt securities and 200 percent for preferred stock.

<sup>16</sup> Money market funds in fact were the first part of the US financial system to be reformed in the wake of the financial crisis. See *Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), 75 Fed. Reg. 10060 (March 4, 2010). Taking the initiative to respond quickly and aggressively to the events of fall 2008, ICI formed the Money Market Working

resilient by, among other things, imposing new credit quality, maturity, and liquidity standards and increasing the transparency of these funds.

The SEC amended Rule 2a-7 again in 2014. The 2014 SEC rules, which took effect on October 14, 2016, largely centered around two principal reforms.<sup>17</sup> The first reform requires prime institutional and tax-exempt institutional money market funds to price and transact in their shares using “floating” net asset values (“NAVs”). The new rules also require these funds to calculate their NAVs to four decimal places. (For a fund with a NAV of \$1.00, that means calculating the NAV to one-hundredth of a penny—*i.e.*, \$1.0000.) Government money market funds<sup>18</sup> and retail money market funds<sup>19</sup> may continue to seek to maintain a stable NAV using amortized cost valuation and/or penny rounding.

The second principal reform enables, and in certain cases requires, all non-government money market funds (*i.e.*, all prime and tax-exempt funds, whether institutional or retail) to impose barriers on redemptions (so-called liquidity fees and gates) during extraordinary circumstances, subject to determinations by a money market fund’s board of directors. Specifically, the new rules give a money market fund’s board the flexibility to impose liquidity fees of up to 2 percent, redemption gates (a delay in processing redemptions for up to 10 business days), or both if the fund’s weekly liquid assets have dropped below 30 percent of its total assets. If a fund’s weekly liquid assets fall below 10 percent of its total assets, the SEC rules require the fund to charge redeeming investors a fee of 1 percent of their redemption, unless the fund’s board determines either that no fee, or a lower or higher fee (not to exceed 2 percent), would be in the best interests of the fund.

The 2014 amendments required funds to make a number of significant operational changes on a very aggressive timeframe. Thanks to substantial effort, planning, and execution within the industry, funds were prepared to meet the new requirements on time and, as a result, the transition went smoothly. When coupled with the 2010 SEC reforms, these new rules add layers of transparency and redundant safeguards that more than adequately address any risks that may have existed in 2008. Indeed, so far-reaching were these last two rounds of reforms that today’s money market fund industry, as indicated in the chart below, is dramatically different from that of 2008.

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Group to study the money market, money market funds, and other participants in the money market, and the financial crisis of 2007-2008. The March 2009 *Report of the Money Market Working Group* addressed these topics and advanced wide-ranging recommendations for the SEC to strengthen money market fund regulation. See Investment Company Act, *Report of the Money Market Working Group* (March 17, 2009), available at [https://www.ici.org/pdf/ppr\\_09\\_mmmwg.pdf](https://www.ici.org/pdf/ppr_09_mmmwg.pdf). The SEC’s 2010 amendments incorporated many of the report’s recommendations.

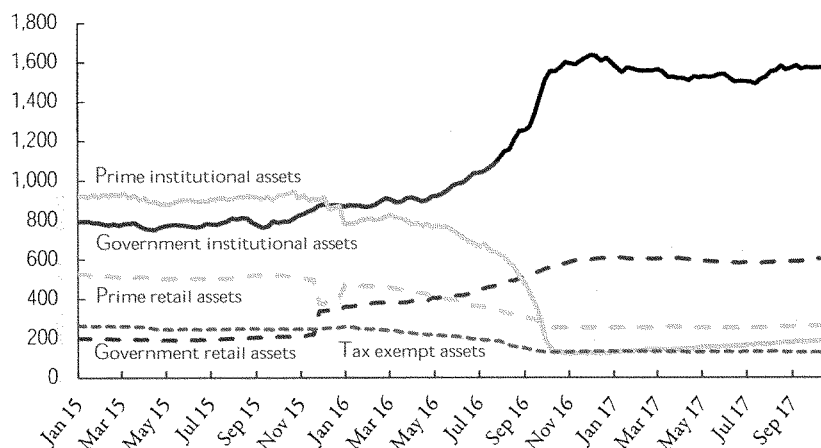
<sup>17</sup> See *Money Market Fund Reform; Amendments to Form PF*, SEC Release No. IC-31166 (July 23, 2014), 79 Fed. Reg. 47736 (August 14, 2014).

<sup>18</sup> Government money market funds invest at least 99.5 percent of their total assets in cash, government securities, and/or repurchase agreements that are collateralized by cash or government securities.

<sup>19</sup> Retail money market funds have policies and procedures reasonably designed to limit all beneficial owners of the fund to natural persons.

Assets Migrated from Prime Money Market Funds and Tax Exempt Money Market Funds into Government Money Market Funds in 2015 and 2016

Total net assets, billions of dollars; week-ended Wednesday, January 7, 2015–October 25, 2017



Source: Investment Company Institute

As the chart shows, in the two years leading up to the October 2016 effective date for the 2014 reforms, large sums shifted from prime money market funds—both institutional and retail—to government money market funds. According to weekly data, from January 7, 2015, to October 25, 2017, assets in prime institutional money market funds dropped \$740 billion. Over the same period, assets in government institutional money market funds rose by a very similar amount, \$785 billion.

A similar, though more muted, shift occurred in retail share classes of money market funds. From January 7, 2015, to October 25, 2017, assets in prime retail money market funds dropped \$266 billion. In addition, over the same period, assets in tax exempt money market funds—the vast majority of which are held by retail investors—fell \$137 billion. Over the same period, assets of government retail money market funds rose by \$398 billion.

#### H.R. 2319

The Consumer Financial Choice and Capital Markets Protection Act of 2017 (H.R. 2319) would rescind many of the 2014 reforms including the requirement that prime institutional and tax-exempt institutional money market funds float their NAVs. In recognition of the importance of money market funds to the global economy and to investors, ICI and its members have closely monitored H.R. 2319 and other efforts to change money market fund regulatory requirements.

Some ICI members have expressed strong interest and support for the bill, believing that it will restore investor choice and increase low-cost financing in the capital markets for business and municipal issuers without amending Rule 2a-7. These members contend that H.R. 2319 would not require any industry participant to change its current products. Rather, it would permit a sponsor to elect to continue to use a floating NAV under Rule 2a-7 for its non-government institutional money market funds or instead to use amortized cost accounting to maintain a stable value for all its funds.

Other ICI members urge that a third round of regulatory changes to money market funds is neither appropriate nor desirable. They contend that their customers are content with the broad set of money market fund investing options still available, that further changes run the risk of making the product more confusing and less attractive, and that the money markets have adjusted to the reforms.

As a result of these strongly differing member views regarding H.R. 2319, ICI takes no position on the proposed legislation.

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I appreciate the opportunity to share these views with the Subcommittee. ICI looks forward to continued engagement with Congress on these important matters.

Appendix A: Registration Process Rule Amendments

Representative Hollingsworth's discussion draft of the "Expanding Investment Opportunities Act" ("Discussion Draft") would amend the following rules under the Securities Act of 1933 ("1933 Act"), the proxy rules, Regulation FD, and Form N-2 under the Investment Company Act of 1940 to improve the registration process for closed-end funds.

Rule 405 under the 1933 Act (Well-Known Seasoned Issuer Status)

Under current Rule 405, "well-known seasoned issuers" or "WKSI" enjoy a streamlined registration process that gives them the flexibility to take advantage of market conditions when offering securities. Specifically, WKSI can file "automatic shelf registrations" that become effective immediately upon filing without the SEC staff's review and comment. This enables WKSI to issue additional shares or other securities more quickly, allowing them to take advantage of current market conditions. To qualify as a WKSI, generally an issuer must have at least \$700 million in common equity outstanding and have timely filed required reports for the preceding 12 calendar months. In addition, the issuer within the past three years must not have engaged in conduct, or be subject to a conviction, decree, or order, that would make it ineligible.<sup>20</sup> Closed-end funds currently are not eligible for treatment as WKSI.

The Discussion Draft would amend Rule 405 to allow closed-end funds to take advantage of it. The amendments would: (1) delete the current exclusion of registered investment companies from the definition of WKSI; and (2) add Form N-2 (the form on which closed-end funds register securities with the SEC) to the definition of "automatic shelf registration statement." (That definition specifies which SEC registration forms a WKSI is permitted to use.)

Notably, closed-end funds that would qualify for WKSI status already will have filed registration statements that have been through the SEC staff review process. The staff thus would have examined these funds' investment objectives, assets, risk disclosures, and other matters that might affect shareholder interests.

Rule 415 under the 1933 Act (Shelf Registration)

Rule 415 governs so-called "shelf registrations." The Discussion Draft would amend Rule 415 in two ways. First, it would require the rule to state explicitly that the shelf registration process is available to any closed-end fund. Closed-end funds already utilize this process in reliance on two SEC staff no-action letters,<sup>21</sup> but it is entirely appropriate for the SEC to codify this time-tested regulatory treatment. This would be a technical but important change.

<sup>20</sup> An issuer would be ineligible, for example, if within the past three years, it filed a bankruptcy petition or had an involuntary bankruptcy petition filed against it, was convicted of a felony or certain misdemeanors, entered into a judicial or governmental decree relating to certain violations of law, or was subject to an SEC stop order.

<sup>21</sup> See Nuveen Virginia Premium Income Municipal Fund (pub. avail. Oct. 6, 2006); Pilgrim America Prime Rate Trust (pub. avail. May 1, 1998).

Second, it would delete the requirement that a registrant using Form N-2 must furnish the undertakings required by Item 34.4 of Form N-2. Those undertakings obligate a closed-end fund, among other things, to file a post-effective amendment to its registration statement to (a) update the fund's financial statements, (b) reflect material changes occurring subsequent to the registration statement's effective date, or (c) include material information as to the fund's plan of distribution not previously disclosed in the registration statement. Filing a post-effective amendment (which would be subject to SEC staff review and comment) in the context of a shelf registration would eliminate the benefits of forward incorporation by reference, discussed below. Moreover, operating companies that qualify to use forward incorporation by reference do not need to make these undertakings.

#### Form N-2 (Forward Incorporation by Reference)

Currently, to incorporate information from other filings (such as shareholder reports) into its registration statement, a closed-end fund must amend its existing registration statement after the filings are made to specifically reference those filings. In other words, the fund must file a post-effective amendment to the registration statement, which entails SEC staff review and comment.

The Discussion Draft would amend Form N-2 to allow a closed-end fund that meets the criteria to be considered a "seasoned issuer" to incorporate by reference into its registration statement annual and semi-annual shareholder reports that the fund files subsequent to the time the registration statement is declared effective. To qualify as a "seasoned issuer," an issuer must have at least \$75 million in common equity outstanding and have made timely periodic filings with the SEC for the preceding 12 calendar months.

This amendment would greatly reduce the time and expense involved in preparing and updating closed-end fund registration statements. And it would provide these benefits without diminishing investor protection. Under the legislation, closed-end funds would be required to indicate in their prospectus if they incorporate any material by reference, and to provide a legend indicating where and how such materials can be obtained.

#### Rule 497 under the 1933 Act (Prospectus Filing Obligations)

Rule 497 governs the filing of investment company prospectuses and requires funds to file final prospectuses. The Discussion Draft would amend Rule 497 to simplify a closed-end fund's prospectus filing obligations. Under the amendments, a fund would be required to file only those prospectuses that contain substantive changes from, or additions to, a prospectus previously filed with the SEC as part of a registration statement—rather than "every form of prospectus" that differs in any way. These changes would conform a closed-end fund's prospectus filing obligations to those for operating companies.

#### Rule 418 under the 1933 Act (Reports of the Registrant)

Rule 418 requires issuers to provide to the SEC "promptly upon request" reports or memoranda relating to broad aspects of the business, operations or products of the registrant, which have been prepared within the past twelve months, but exempts operating companies that meet certain criteria

from this requirement.<sup>22</sup> The Discussion draft would amend the rule to provide closed-end funds that meet the same criteria with an exception from this requirement, treating closed-end funds the same as similar operating companies.

Rule 14a-101 under the Securities Exchange Act of 1934 (Proxies)

Rule 14a-101 allows operating companies that meet certain criteria<sup>23</sup> to incorporate by reference into proxy statements previously filed documents, such as annual reports. The Discussion Draft amends the proxy rules to extend to closed-end funds that qualify the same benefits that operating companies already enjoy.

Rule 103 of Regulation FD (Reporting of Non-Public Information)

Regulation FD requires issuers (including closed-end funds) disclosing any material non-public information to certain persons also to disclose the information to the public. Public disclosure must be made simultaneously, in the case of an intentional disclosure, and promptly, in the case of a non-intentional disclosure. Rule 103 provides that any failure to make such disclosures should not affect whether an issuer has complied with its reporting obligations under the Securities Exchange Act of 1934. The Discussion Draft amends Rule 103 of Regulation FD to extend to closed-end funds this technical relief, which currently is limited to operating companies.

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<sup>22</sup> The exception extends to a wider range of entities than just WKSIs and seasoned issuers. It applies to any issuer that: (a) has equity securities listed and registered on a national securities exchange; (b) has not sold securities amounting to more than one-third of its outstanding securities in certain offerings over the previous 12 calendar months; and (c) is not a shell company and has not been a shell company for at least 12 calendar months.

<sup>23</sup> These criteria are the same as those described in the preceding footnote.



Appendix B: Communications Process Rule Amendments

Representative Hollingsworth's discussion draft of the "Expanding Investment Opportunities Act" ("Discussion Draft") would amend the following rules under the Securities Act of 1933 ("1933 Act") to improve the communications process for closed-end funds.

Rules 164 and 433 ("Free Writing Prospectuses")

Rules 164 and 433 permit an operating company to utilize the "free writing prospectus" safe harbors. A "free writing prospectus" is any written communication deemed to be an offer of a security that does not meet the full requirements of a statutory prospectus set forth under the 1933 Act (including any television or radio broadcast).

Rule 164 permits an issuer to use such a prospectus when it meets the conditions of Rule 433. Rule 433, in part, allows a WKSI issuer to use a free writing prospectus at any time during an offering once the registration statement has been filed, with no requirement to deliver a statutory prospectus with or in advance of the free writing prospectus. The safe harbor, among other things, requires that the issuer file any free writing prospectus with the SEC prior to its date of first use. To qualify as a WKSI, generally an issuer must have at least \$700 million in common equity outstanding and have timely filed required reports for the preceding 12 calendar months. In addition, the issuer within the past three years must not have engaged in conduct, or be subject to a conviction, decree, or order, that would make it ineligible.<sup>24</sup>

The Discussion Draft would permit a closed-end fund that meets the WKSI criteria to utilize free writing prospectuses. Currently, many closed-end funds rely on Rule 482 under the 1933 Act to provide communications to investors and prospective investors, which permits funds to use a broad range of advertisements after a registration statement has been filed. While Rule 482 communications could in theory be a satisfactory substitute for free writing prospectuses, Rule 482 includes filing requirements (*e.g.*, for certain electronic road show materials) that do not apply under Rule 433. The additional filing requirements mean that closed-end funds must shoulder additional expenses as compared to operating companies, with no clear justification.

Rule 134 ("Tombstone Ads")

Under Rule 134, an operating company may make certain limited written communications regarding an offering after a registration statement has been filed without causing the communications to be considered a prospectus or free writing prospectus. These communications, known as "tombstone ads," permit issuers to provide specified facts about the legal identity and business of the issuer, and underwriters of an offering.

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<sup>24</sup> An issuer would be ineligible, for example, if within the past three years, it filed a bankruptcy petition or had an involuntary bankruptcy petition filed against it, was convicted of a felony or certain misdemeanors, entered into a judicial or governmental decree relating to certain violations of law, or was subject to an SEC stop order.

The Discussion Draft would amend Rule 134 to permit any closed-end fund to use tombstone ads. Registered funds currently can provide this same information in Rule 482 communications, but those communications are subject to prospectus liability because the Rule 482 communications are deemed to be prospectuses. Closed-end funds should have the same ability as operating companies to issue these narrowly circumscribed communications that do not entail the added threat of prospectus liability.

Rules 163 and 163A (Pre-Filing Communications)

Under Rule 163, WKSJ may make oral or written offers prior to the filing of a registration statement. In addition, Rule 163A provides a safe harbor to operating companies for any communication that is made more than 30 days before the filing of a registration statement, when that communication does not reference the offering that is or will be the subject of that registration statement. Although the securities laws typically prohibit many types of communications before the filing of a registration statement on the theory that they could “condition” the market or draw interest for the offering, the SEC has deemed it appropriate to adopt safe harbors that permit operating company issuers to communicate more freely to the public during these periods.

The Discussion Draft would permit a closed-end fund that is a WKSJ to rely on Rule 163, and any closed-end fund to rely on Rule 163A, to make pre-filing communications. Unlike Rule 482, which only provides a safe harbor for qualifying communications that follow the filing of a registration statement, these safe harbors would provide flexibility to a closed-end fund to communicate with the public during the period prior to the filing of a registration statement.

Rules 168 and 169 (Factual Business Information)

An operating company may communicate certain information provided in the ordinary course of business prior to or during an offering. Specifically, Rule 168 establishes a safe harbor for an issuer that already is filing periodic reports with the SEC to continue to disseminate regularly released or factual business information and forward-looking information prior to or during a registered offering. Rule 169 establishes a similar safe harbor for an issuer that does not file periodic reports to disseminate regularly released or factual business information (but not forward-looking information) prior to or during a registered offering. Both safe harbors define “factual business information” to include information about the issuer, its business or financial developments, or other aspects of its business, as well as advertisements, and require that the information must have been previously released in the ordinary course of business.

The Discussion Draft would amend Rules 168 and 169 to permit a closed-end fund to communicate certain factual business information about the closed-end fund, its business or other developments at any time before or during an offering. Permitting a closed-end fund to rely on these safe harbors could encourage the fund to issue more useful and timely reports regarding its business without the fear that doing so could subject it to liability (on the theory that it is making an offering of its securities without first delivering a statutory prospectus).

Rules 138 and 139 (Research Reports)

Broker-dealers that provide research on an operating company may rely on two safe harbors that encourage the publication and distribution of research reports during an offering. Rule 138 permits a broker-dealer participating in a registered offering to publish and distribute research reports about securities of the issuer that are not the subject of the offering. (For example, it permits a broker-dealer that is serving as an underwriter of an issuer's current debt offering to write research reports about the issuer's common stock.) Rule 139 permits a broker-dealer that participates in a registered offering to issue research reports specifically about the issuer and its securities or the issuer's industry or sub-industry under specified conditions. Under Rule 139, the issuer must qualify as a "seasoned issuer" and the broker-dealer must distribute research reports in the regular course of its business.

The Discussion Draft would permit a broker-dealer providing reports on a closed-end fund to rely on the two research report safe harbors. Similar to the factual business information safe harbors discussed above, the research report safe harbors would encourage additional reporting about a closed-end fund and its securities. As a closed-end fund often issues both common and preferred stock, permitting broker-dealers to rely on the first safe harbor (under Rule 138) would allow for more coverage of a closed-end fund's issuances.

Similarly, the second safe harbor (under Rule 139), which would be available only to closed-end funds that meet criteria for "seasoned issuers," might encourage broker-dealers to issue and distribute more research reports about specific closed-end fund issuances or the closed-end fund's industry or sub-industry. To qualify as a "seasoned issuer," an issuer must have at least \$75 million in common equity outstanding and have made timely periodic filings with the SEC for the preceding 12 calendar months.

Earlier this fall, Congress passed, and the President enacted, the Fair Access to Investment Research Act of 2017. That Act requires the SEC to amend Rule 139 to permit broker-dealers providing reports on "covered investment funds," including exchange-traded funds, to rely on that safe harbor. Although closed-end funds technically are within the definition of "covered investment fund," the law seems to have excluded broker-dealer reports about closed-end funds from its scope. The Discussion Draft would correct this flaw.

Rule 172 and 173 (Prospectus Delivery)

Rule 172 permits a traditional operating company to meet its prospectus delivery obligations when it makes a good faith and reasonable effort to timely file a final statutory prospectus with the SEC. The rule also permits operating company issuers to deliver a written confirmation to shareholders without treating the confirmation as a prospectus. Rule 173 permits each underwriter or broker-dealer participating in an offering of an operating company's securities to satisfy its prospectus delivery obligations by furnishing a notice within two business days after a purchase that states that the sale was made pursuant to an effective registration statement or in a transaction pursuant to Rule 172.

Operating companies, underwriters, and broker-dealers may rely on these rules to satisfy their prospectus delivery obligations once the company's registration statement is declared effective.

The Discussion Draft would enable a closed-end fund to meet its obligation to deliver a final prospectus during an initial public offering or follow-on offering without having to deliver the prospectus. Permitting a closed-end fund and underwriters and broker-dealers participating in an offering to utilize these safe harbors will save funds and their shareholders the expense of delivering final prospectuses. Although a closed-end fund only is required to provide prospectuses during the offering period, which typically lasts 40 days after the offering begins, the expenses of meeting these obligations can be quite significant. Moreover, permitting reliance on these safe harbors for closed-end fund offerings would put them on an equal footing with traditional operating company offerings, which have availed themselves of these two safe harbors since 2005.

JEB HENSARLING, TX, CHAIRMAN

United States House of Representatives  
Committee on Financial Services  
2129 Rayburn House Office Building  
Washington, DC 20515

MAXINE WATERS, CA, RANKING MEMBER

September 14, 2017

The Honorable Jay Clayton  
Chairman  
U.S. Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Dear Chairman Clayton,

As you know, in 2014, the Securities and Exchange Commission (SEC) approved a final rule to require institutional prime money market funds (MMFs) to adopt market-based pricing and float the fund's net asset value (NAV). The final rule also authorized the boards of MMFs to impose liquidity fees and redemption gates during periods of stress. The SEC's final rule provided MMFs with two years to comply with these new requirements, which ultimately became effective on October 14, 2016. The final rule also permits government and retail MMFs to use the method to seek and maintain a fixed NAV.

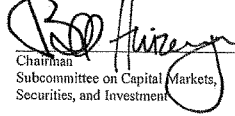
Some market participants and commentators have expressed the concern that the SEC's 2014 MMF rule would result in the loss of short-term liquidity in the capital markets, particularly in the municipal securities market. With the experience of the past eleven months, we ask the SEC to review the current landscape for MMFs and the impact of the 2014 rule on both short-term corporate and municipal financing. Specifically, we would welcome your views to the following questions:

1. What was the impetus behind the SEC's 2014 money market reforms? How has the implementation of these reforms addressed those issues?
2. Has the SEC conducted a comprehensive review of short-term lending, especially with regard to MMFs, since the 2014 money market reforms became effective on October 14, 2016? If not, does the SEC plan to conduct such a review?
3. How has the landscape for money market funds changed since the approval of the SEC's 2014 money market fund rules? Have there been significant shifts in these markets since the October 2016 effective date?
4. What concerns, if any, has the SEC heard in response to the implementation of the 2014 MMF reforms?
5. What impacts have the 2014 money market reforms had on short-term financing and liquidity?
6. What other market conditions or regulatory initiatives, if any, have impacted the market for money market funds?
7. What would be the impact on prime and municipal MMFs if the SEC was to reverse its rule and revert to a constant \$1.00 share price?

Thank you for your attention to this important matter. Please respond in writing by October 2, 2017.

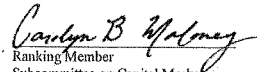
Sincerely,

BILL HUIZENGA



Chairman  
Subcommittee on Capital Markets,  
Securities, and Investment

CAROLYN MALONEY



Ranking Member  
Subcommittee on Capital Markets,  
Securities, and Investment



UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

October 5, 2017

The Honorable Bill Huizenga  
Chairman  
Subcommittee on Capital Markets, Securities, and Investment  
Committee on Financial Services  
U.S. House of Representatives  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Huizenga:

Thank you for your letter dated September 14, 2017 concerning the market effects to the regulation of money market funds ("MMFs") that the Commission adopted in 2014 and which were fully implemented in October of last year. I appreciate your interest in this issue and share your goal of preserving liquidity in the short-term funding markets and minimizing disruptions to investors, markets, and market participants.

The Commission, in the 2014 release adopting the reforms, indicated that the impetus behind the reforms was a concern that MMFs, as they existed then, could pose risks to investors and the broader markets, particularly to the extent their features may have created a first-mover advantage that incentivized investor runs during periods of market stress. The Commission's adopting release further noted the harm that can result from rapid investor redemptions during periods of market stress, as the Reserve Fund's Primary Fund "broke the buck" and other prime institutional funds experienced heavy redemptions — which in turn caused fund managers to retain cash, thereby freezing short-term financing markets. Ultimately, as the 2014 release describes, the Department of the Treasury intervened with its Temporary Guarantee Program — extraordinary measures that helped quiet the market disruptions. Treasury was subsequently prohibited by statute from undertaking such measures in the future, thereby creating the need for structural reforms to the markets to prevent such disruptions going forward.

Accordingly, the 2014 reforms included certain structural reforms designed to mitigate run risk in MMFs. These included a floating NAV for all institutional prime (e.g., non-government and retail) MMFs designed to address potential first-mover advantages. The reforms also provide non-government MMF boards new tools — liquidity fees and redemption gates — which are designed to help MMFs better manage any potential investor run should one occur.

The staff have been closely monitoring the implementation of the 2014 reforms and reviewing their impact on MMFs and the short-term funding markets. Based on their review and analysis, the staff have shared the following observations.

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The Honorable Bill Huizenga

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- As MMFs were implementing the 2014 reforms, there was a shift in assets of approximately \$1.1 trillion from prime MMFs into government MMFs. Despite this reallocation, overall MMF assets remained largely stable (at about \$3 trillion) throughout this period and to date.
- During this period, some short-term rates increased, though these rate increases have since dissipated. The reallocation of assets from prime to government MMFs and potential effects on yields in the short-run were possible consequences of the reforms that were anticipated and discussed in the rule's 2014 adopting release. At that time, the Commission determined, however, that realizing the goals of the rulemaking justified the reforms, despite the potential costs.
- Since the October 2016 compliance date for the reforms, investor fund reallocations have not significantly changed, with assets in both government and prime MMFs largely stabilizing. The time period since the compliance date of the reforms has also coincided with a rising interest rate environment, with the Federal Reserve raising short-term interest rates several times over the last year. This has resulted in yield increases for MMFs.

The staff have further informed me that, as the reforms went into effect, many fund managers chose to realign their fund offerings and close certain funds, many of whose assets had been shrinking during the extended low interest rate environment. These changes have led to some reductions in investment in prime and municipal MMFs, particularly when combined with the reallocation of assets from prime to government funds that I mentioned above. To the extent that MMFs experiencing outflows invested more heavily in certain types of assets than the MMFs receiving inflows during this period, those types of assets could be experiencing decreased demand from MMFs. Some market participants and corporate and municipal issuers suggest that this decrease in demand for commercial paper and short-term municipal securities from MMFs and related increase in demand for government securities from MMFs is one of the primary impacts of the 2014 reforms on the short-term funding market.

I appreciate your question regarding the SEC potentially reversing the floating NAV element of the 2014 reforms. It is difficult at this time, however, to predict what the impact on prime and municipal funds would be if the Commission were to permit them again to use a stable \$1.00 NAV. While some investors might choose to leave government MMFs and return to prime and municipal funds, such a shift also might not occur if investors newly appreciate prime and municipal MMFs' inherent liquidity and principal stability risks and therefore choose to remain in government MMFs. The MMF reforms were not fully implemented until October 2016, and I am concerned that making major changes at this time could be disruptive to the short-term funding markets. The Commission and its staff are monitoring the short-term funding markets and MMFs' activities generally, and will remain focused on the role MMFs play for investors and the short-term markets.

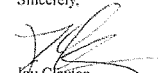
Thank you again for your letter and for your attention to this important matter in our capital markets. Should you wish to discuss these issues further, please do not hesitate to contact



The Honorable Bill Huizenga  
Page 3

me at (202) 551-2100 or have your staff contact Bryan Wood, Director of the Office of  
Legislative and Intergovernmental Affairs, at (202) 551-2010.

Sincerely,



Jay Clayton  
Chairman

Government Finance Officers Association  
 U.S. Conference of Mayors  
 National Association of Counties  
 National League of Cities  
 International City/County Management Association  
 Large Public Power Council  
 National Association of Health and Educational Facilities Finance Authorities  
 International Municipal Lawyers Association  
 National Council of State Housing Agencies  
 American Public Power Association

October 13, 2017

The Honorable Michael Crapo  
 Chairman  
 Committee on Banking  
 United States Senate  
 Washington, DC 20515

The Honorable Sherrod Brown  
 Ranking Member  
 Committee on Banking  
 United States Senate  
 Washington, DC 20510

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

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

Dear Chairmen Crapo and Hensarling, and Ranking Members Brown and Waters:

The organizations listed above, representing state and local governments, authorities and other public entities, wish to express their support for H.R. 2319/S. 1117, *The Consumer Financial Choice and Capital Markets Protection Act*.

Our organizations have long opposed the Securities and Exchange Commission (SEC) modifications to SEC Rule 2a-7 of the Investment Company Act of 1940 that changed the net-asset-value (NAV) accounting methodology for money market mutual funds (MMMF) from stable to floating. Our members rely on the hallmark stable NAV feature in a variety of ways. First, many governments have specific state or local statutes and policies that require them to invest in financial products with a stable NAV. The policy reason for this is to ensure that public funds are appropriately safeguarded to best serve the entity. Second, MMMFs with a stable NAV are the most commonly used investment by state and local governments. Forcing governments to find alternative investments to MMMFs creates additional risk for public funds by driving them to potentially invest in other, less suitable products. Finally, non- MMMF options may not meet liquidity standards required by their governments to meet cash management policies and statutes. H.R. 2319/S. 1117 would enable state and local governments to continue to use stable NAV funds for their essential and critical investment needs.

In addition to the vital use of MMMFs as state and local government investments, it is important to note that MMMFs are the largest purchasers of short term municipal securities. Due to the new SEC rules, these funds have curbed their appetite for these securities, thus decreasing demand and increasing costs to state and local governments that issue this type of debt. In fact, between January 2016 and July 2017, tax

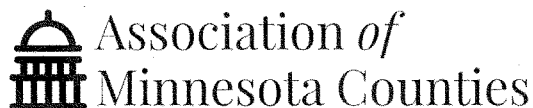
exempt MMMFs assets fell by 50 percent, from \$254 billion to \$135 billion, thereby dramatically shrinking the funding pool available to municipal borrowers. Over 30 states lost at least \$1 billion in funding from tax-exempt MMMFs. At the same time, municipalities fortunate enough to continue selling their debt to tax-exempt funds saw their borrowing costs increase by nearly double the Federal Reserve's rate increases over the same period. Those costs have increased even more for state and local governments that can no longer sell their debt to MMMFs, and have to borrow from other investors or replace the debt with bank loans.

Money market funds have been utilized effectively in the past to both manage liquidity and provide a reliable source of working capital to fund public services and finance continued infrastructure investment and economic development throughout all economic conditions. This is particularly important today as states and communities impacted by recent devastating hurricanes and other natural disasters seek to finance rebuilding and recovery efforts. We ask that you enact H.R. 2319/S. 1117 so that state and local governments can continue to have unrestricted access to these safe and highly liquid capital markets tools.

Thank you again for considering this important legislation. We look forward to working with you and supporting your efforts to help state and local governments on this and other regulatory and financial matters of mutual interest.

Sincerely,

Emily Swenson Brock, Government Finance Officers Association, 202-393-8467  
Larry Jones, United States Conference of Mayors, 202-861-6709  
Jack Peterson, National Association of Counties, 202-661-8805  
Brett Bolton, National League of Cities, 202-626-3023  
Elizabeth Kellar, International City/County Management Association, 202-962-3611  
Noreen Roche-Carter, Large Public Power Council, 916-732-6509  
Chuck Samuels, National Assn of Health & Educational Facilities Finance Authorities, 202-434-7311  
Chuck Thompson, International Municipal Lawyers Association, 202-466-5424  
Garth Riemann, National Council of State Housing Agencies, 202-624-7710  
John Godfrey, American Public Power Association, 202-467-2929



September 21, 2016

The Honorable Tom Emmer  
United States House of Representatives  
503 Cannon HOB  
Washington, D.C. 20515

Dear Congressman Emmer:

The Association of Minnesota Counties (AMC) respectfully brings to your attention the looming impacts of an amendment to Securities and Exchange Commission (SEC) rule 2A-7 and the adverse effects this move will have on the investment value of municipal bonds for Minnesota counties.

As you may know, counties use tax-exempt debt to finance various capital and public works projects. In this regard, money market funds ("MMFs") are significant purchasers of tax-exempt obligations. Starting in October, we fear that once the net asset value changes from a fixed sum to floating value—pursuant to the new SEC rule—MMFs may no longer be interested in purchasing such debt. Without MMFs to purchase municipal bonds, the cost of projects will be incrementally more expensive, limiting our future growth and adding a new cost to taxpayers. In addition, obtaining the lowest possible interest costs for tax-exempt financing is an especially important tool to fund county public works and other infrastructure projects and facility upgrades.

As such, we ask for your support of H.R.4216 to benefit not only Minnesota residents, but local governments, business owners, developers, and the construction trades by preserving stable value money market funds for public infrastructure investment, economic development, and growth. As a member of the U.S. House Financial Services Committee, we know that you are in a unique position to request a hearing for this bill or to relay Minnesota counties' concerns to members of the committee.

Thank you for your attention to this issue, we greatly appreciate your consideration. Please feel free to contact my office should you have any questions or requests for specific county information.

Sincerely,



Julie Ring, Executive Director  
Association of Minnesota Counties

JR: MH



December 1, 2016

The Honorable Paul Ryan  
Speaker of the House  
United States Capitol  
Washington, D.C. 20515

Dear Mr. Speaker:

As you work to complete the legislative activity of the 114<sup>th</sup> Congress, we ask that you include in that process the expeditious enactment of H.R. 4216, the Consumer Financial Choice and Capital Markets Protection Act. This bipartisan legislation, and its counterpart in the Senate (S. 1802, sponsored by Senator Pat Toomey) would address the significant unintended consequences of a Securities and Exchange Commission (SEC) rule which is undermining business and public infrastructure investment, and crimping state and local government finances.

As members of the State Financial Officers Foundation (SFOF), we are dedicated to developing, implementing and promoting conservative, fiscally responsible ("pro-growth") public policies. Those policies include maintaining efficient, low cost financing provided by money market funds, and maintaining access to a convenient and safe tool for obtaining market returns on cash in the management of public money.

Unfortunately, both of those objectives have been severely undermined by an SEC rule adopted two years ago, which went into effect six weeks ago. It requires institutional prime and tax-exempt money market funds to be offered only with a floating net asset value (NAV). Under this rule, only funds investing solely in U.S. government securities or offered only to certain retail investors who are "natural persons" may continue to use a stable NAV. This rule has led to a run on prime and tax-exempt money market funds, causing more than \$1.2 trillion to no longer be available for business and public infrastructure investment. As a result, short-term interest rates have risen to their highest levels since the financial crisis, issuers of commercial paper have seen their cost of borrowing more than double, and issuers of municipal debt and their borrowers have all seen their cost of short-term financing rise from, in some cases, below five basis points last November to nearly 80 basis points today.

At the same time that the rule has caused our cost of short-term borrowing to rise dramatically, it has also driven down our investment income. As a result of the floating NAV rule, yields on prime money market funds are double that of government funds, but state and local governments are unable to benefit from those market rates of return on their short-term cash investments. This is reducing our projected revenue, making it more difficult to fund public services.

Even though the implementation date of the SEC rule has passed, the negative impacts persist as institutions continue to pull their investments out of prime and tax-exempt money market funds, leading to more fund liquidations and less private capital for our communities and businesses. Enactment of H.R. 4216 and S. 1802 is urgently needed to address this artificially created financial crisis caused by over-regulation and a failure by the SEC to conduct realistic cost-benefit analyses.

We look forward to working with you, alongside the new Administration, to advance conservative, pro-growth economic policies. Enactment of H.R. 4216 and S. 1802 would be a welcome step in that direction.

P.O. Box 9584 ▲ Mission, KS 66201 ▲ (866) 816-0873 ▲ [www.statefinancialofficers.com](http://www.statefinancialofficers.com)

Sincerely,



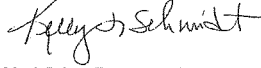
Derek Kreifels, President  
State Financial Officers Foundation



Mississippi Treasurer Lynn Fitch, National Chair  
State Financial Officers Foundation



Idaho Treasurer Ron Crane, Vice Chair  
State Financial Officers Foundation



North Dakota Treasurer Kelly Schmidt, Past Chair  
State Financial Officers Foundation



Arizona Treasurer Jeff DeWit



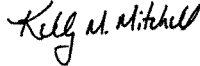
Arkansas Treasurer Dennis Milligan



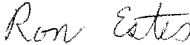
Colorado Treasurer Walker Stapleton



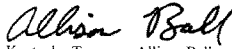
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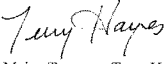
Indiana Treasurer Kelly Mitchell




Kansas Treasurer Ron Estes



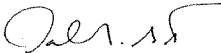
Kentucky Treasurer Allison Ball



Maine Treasurer Terry Hayes



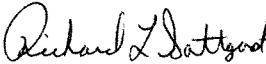
Nevada Controller Ronald Knecht



Nevada Treasurer Dan Schwartz



South Carolina Treasurer Curtis Loftis



South Dakota Treasurer Richard Satgast



Wyoming Treasurer Mark Gordon



**Thomas P. Koch**  
Mayor

**City of Quincy**  
**City Hall**  
*Office of the Mayor*



September 21, 2017

The Honorable Stephen Lynch  
2268 Rayburn HOB  
Washington, DC 20515

***Re: Support for the Consumer Financial Choice and Capital Markets Protection Act of 2017 (H.R. 2319)***

Dear Representative Lynch,

As the Mayor of Quincy, a city that relies on a stable, low-risk municipal bond market, I respectfully urge you to support *H.R. 2319, The Consumer Financial Choice and Capital Markets Protection Act of 2017*, which would undo damaging new rules imposed on municipal money market funds (MMMFs) by the Securities and Exchange Commission (SEC). I joined Governor Patrick, Treasurer Grossman, the Massachusetts Municipal Association and others in opposing this rule in comments to the SEC when they considered the rule in 2013 and 2014, and am extremely disappointed that they moved forward with it.

These regulatory changes require a floating net asset value (NAV) for MMMFs as opposed to the prior fixed NAV of \$1 per share. The low risk provided by the fixed NAV was an essential municipal financial tool, and I am deeply concerned by the way these changes make municipal bonds less attractive to investors. As municipal bonds became substantially less attractive to investors, municipal funds, a key source of funding for state and local governments and their infrastructure projects, experienced a 50 percent decline since the implementation of the rule.

In our city of Quincy, municipal bonds are the financial backbone for what is the most ambitious urban center redevelopment program in the Northeast, having provided for tens of millions of dollars in infrastructure improvements.

H.R. 2319, which will allow these MMMFs to regain the essential fixed net asset value, is vital to our city of Quincy and cities nationwide. Thus, I again respectfully urge you to support this legislation.

Thank you in advance for your consideration.

Regards,

Thomas P. Koch  
Mayor

1305 Hancock Street, Quincy, MA 02169  
617-376-1990 ~ [mayorkoch@quincyma.gov](mailto:mayorkoch@quincyma.gov)



**Thomas P. Koch**  
Mayor

**City of Quincy**  
**City Hall**  
*Office of the Mayor*



September 21, 2017

The Honorable Elizabeth Warren  
United States Senate  
317 Hart Senate Office Building  
Washington, DC 20510

The Honorable Edward Markey  
United States Senate  
255 Dirksen Senate Office Building  
Washington, DC 20510

***Re: Support for the Consumer Financial Choice and Capital Markets Protection Act of 2017 (S.1117)***

Dear Senator Warren and Senator Markey,

As the Mayor of Quincy, a city that relies on a stable, low-risk municipal bond market, I respectfully urge you to support Senate Bill 1117, *The Consumer Financial Choice and Capital Markets Protection Act of 2017*, which would undo damaging new rules imposed on municipal money market funds (MMMFs) by the Securities and Exchange Commission (SEC). I joined Governor Patrick, Treasurer Grossman, the Massachusetts Municipal Association and others in opposing this rule in comments to the SEC when they considered the rule in 2013 and 2014, and am extremely disappointed that they moved forward with it.

These regulatory changes require a floating net asset value (NAV) for MMMFs as opposed to the prior fixed NAV of \$1 per share. The low risk provided by the fixed NAV was an essential municipal financial tool, and I am deeply concerned by the way these changes make municipal bonds less attractive to investors. As municipal bonds became substantially less attractive to investors, municipal funds, a key source of funding for state and local governments and their infrastructure projects, experienced a 50 percent decline since the implementation of the rule.

In our city of Quincy, municipal bonds are the financial backbone for what is the most ambitious urban center redevelopment program in the Northeast, having provided for tens of millions of dollars in infrastructure improvements.

S.1117, which will allow these MMMFs to regain the essential fixed net asset value, is vital to our city of Quincy and cities nationwide. Thus, I again respectfully urge you to support this legislation.

Thank you in advance for your consideration.

Regards,

Thomas P. Koch  
Mayor

1305 Hancock Street, Quincy, MA 02169  
617-376-1990 ~ mayorkoch@quincyma.gov





November 2, 2017

The Honorable Jeb Hensarling  
Chairman  
Committee on Financial Services  
U.S. House of Representatives  
Washington, DC 20515

The Honorable Bill Huizenga  
Chairman  
Subcommittee on Capital Markets and GSEs  
U.S. House of Representatives  
Washington, D.C. 20515

The Honorable Maxine Waters  
Ranking Member  
Committee on Financial Services  
U.S. House of Representatives  
Washington, DC 20515

The Honorable Carolyn Maloney  
Ranking Member  
Subcommittee on Capital Markets and GSEs  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Representatives Hensarling, Waters, Huizenga and Maloney:

On behalf of the Association for Financial Professionals (AFP), I am writing to request your support for H.R. 2319, the Consumer Financial Choice and Capital Markets Protection Act, which will be the subject of a Capital Markets Subcommittee hearing on November 3. This legislation seeks to preserve business access to liquidity for cash management, and capital access for business and public infrastructure investment.

As the global resource and advocate for the finance profession, AFP serves over 16,000 members who manage and safeguard the financial assets of more than 5,000 U.S. organizations. Many of our members are responsible for issuing short- and long-term debt and for managing the corporate cash, 401k and pension assets of their organizations. In these fiduciary capacities, our members rely on money market funds as both investors and issuers of debt.

Unfortunately, the flexibility, efficiency and lower cost that money market funds provide was undermined by a Securities and Exchange Commission (SEC) rule that took effect in October 2016. The rule in question prohibits prime and tax-exempt money market funds operating on a stable net asset value (NAV) basis from being offered to investors other than "natural persons." As a result, organizations that require stable value investments have been forced to shift their short-term cash management needs out of these money market funds and into other types of investments that do not support the capital access needs of businesses and communities.

As a result of the implementation date of the floating NAV rule, the capital pool that is available to business borrowers shrank by about \$160 billion since the beginning of 2016, while many businesses are pay higher rates to alternative lenders. At the same time, municipal entities and non-government conduit borrowers, such as hospitals and universities, have seen their borrowing costs increase from under 10 basis points to about 90 basis points over the same period.

Our members prefer money market funds over other investment vehicle because they provide liquidity, principal preservation, diversification, built-in credit analysis, and ease of accounting. In addition, these funds are a key source of short-term financing for businesses to purchase seasonal inventory, pay suppliers, and fund payroll and other expenses when cash outflows are greater than inflows. Issuing short-term variable rate debt held by money market funds is preferable to secured bank loans for businesses because it provides more efficient and affordable short-term financing, and allows businesses to invest more in job creating activities.

It is important that H.R. 2319 be enacted as quickly as possible to reverse the long-term damage being done to the indispensable capital markets financing options provided by money market funds. The legislation will provide accounting consistency in our global money funds market while maintaining other recently adopted regulations regarding asset maturities, credit quality, and transparency.

I appreciate your leadership in advancing H.R. 2319 as quickly as possible, and am available to answer any questions or provide additional information.

Sincerely,



Jeff A. Glenzer  
Chief Operating Officer  
Association for Financial Professionals  
4520 East-West Highway, Ste. 800  
Bethesda, MD 20814  
301-961-8872

cc: Members of the House Financial Services Committee



November 2, 2017

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

The Honorable Bill Huizenga  
Chairman  
Subcommittee on Capital Markets and GSEs  
U.S. House of Representatives  
Washington, D.C. 20515

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

The Honorable Carolyn Maloney  
Ranking Member  
Subcommittee on Capital Markets and GSEs  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Representatives Hensarling, Waters, Huizenga, and Maloney,

**The Association of School Business Officials International (ASBO) is an education association that, through its members and affiliates, represents approximately 30,000 school business professionals.** ASBO International members are trusted stewards of taxpayers' investment in public K-12 education and represent every aspect of school support services, including school finance, procurement, facilities management, human resources, technology, transportation, and more. **We are writing to ask for your support of H.R. 2319, the "Consumer Financial Choice and Capital Markets Protection Act," and to urge the Financial Services Committee to act on this bipartisan legislation as quickly as possible.**

H.R. 2319 would preserve access to an important source of capital and promote low-cost financing for school facilities and other public infrastructure investments. As the financial leaders and facility managers of school districts, ASBO members depend on tax-exempt money market funds (MMFs) for readily available, low-cost capital expenditure financing for school construction projects. Unfortunately, this financing option is no longer feasible because of a Securities and Exchange Commission (SEC) rule that took effect in October 2016. The rule prohibits tax-exempt MMFs from operating on a stable net asset value (NAV) basis, and now must operate on a floating NAV instead. This change has caused investors to flee tax-exempt funds, which has unnecessarily raised the cost of financing school construction projects.

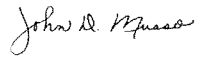
Tax-exempt MMFs are among the largest purchasers of variable rate notes issued by or on behalf of school districts and other educational institutions. They have a nominal long-term maturity, but the interest rate is adjusted on a daily or weekly basis. As a result, schools districts across the country are able to undertake long-term infrastructure projects at very low short-term rates. At the beginning of 2016, the cost of borrowing

at those adjustable rates was as low as a few basis points (BPS). Those rates have skyrocketed to about 90 BPS as a result of the SEC's floating NAV rule. By driving up the cost (and increasing the unpredictability) of borrowing, the SEC rule is squeezing school district budgets and undermining district leaders' efforts to provide safe educational facilities for our children to grow in and learn.

**Please support H.R. 2319 so that we can preserve stable value MMFs as a viable, efficient, and cost-effective source of financing school facilities and other important public infrastructure investments.**

Thank you for your leadership on this issue. If you have any questions or would like to discuss H.R. 2319 in further detail, please feel free to contact us at 866.682.2729.

Sincerely,

A handwritten signature in black ink that reads "John D. Musso". The signature is written in a cursive style with a large initial "J" and "M".

John D. Musso, CAE, RSBA  
Executive Director  
ASBO International

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**Commentary****Money Market Funds on Life Support**By [Mercer Bullard](#) | 10-03-12 | 06:00 AM | [Email Article](#)

Three years ago, I asked: [Will Obama Kill Money Market Funds?](#) He certainly is trying, but the MMF industry is not going down without a fight. It scored a victory in round one when SEC chairman Mary Schapiro [gave up](#) trying to persuade her fellow commissioners to support reforms that the industry argues would, in effect, eliminate MMFs as we know them. This battle has now moved to round two with Treasury secretary Timothy Geithner's [request to the Financial Stability Oversight Council](#) to pick up where the SEC has left off.

Geithner's request is probably more bark than bite. It would be imprudent for a novice regulator such as FSOC to test its new powers in a fight with industry and Congress (see [Sen. Pat Toomey's comments](#)) that it may lose. And if chairman Schapiro leaves the commission, which some have predicted, her replacement may take up MMF reform again, in which case FSOC action would not be needed.

At this point, the best bet might be that the SEC will revisit MMFs late this year or early in the next and issue a request for data on the potential effect of additional reforms. However, this will provide only a brief respite. Geithner has thrown down a gauntlet that promises an epic showdown between the banking and securities models of financial regulation that is likely to reach a boiling point in the next couple of years.

**Financial Crisis Fallout**

The MMF battle is a residue of the financial crisis. In September 2008, the failure of Lehman Brothers caused the Reserve Money Market Fund's per-share net asset value to drop below \$1. The [Reserve Fund's "breaking a dollar,"](#) along with the other stresses of the financial crisis, precipitated large withdrawals from that fund and other MMFs. Before the run on MMFs could metastasize, the Treasury Department announced that it would insure investors' MMF accounts, which calmed investors and stopped the exodus.

Banking regulators insist that the MMF run proved that MMFs present systemic risk to our financial markets. The Dodd-Frank Act of 2010 purported to address such systemic risks in part by creating the banker-dominated FSOC, which has the authority to brand nonbanks as systemically important financial institutions, or SIFIs. If the FSOC declared MMFs to be SIFIs, then they would become subject to oversight by the Federal Reserve.

Schapiro's SEC responded to systemic-risk concerns by adopting fairly draconian [MMF reforms in 2010](#). Banking regulators were not satisfied, however, and demanded that the SEC take more extreme measures.

So Schapiro moved to propose further reforms that would require MMFs to choose between: 1) allowing their NAVs to float like any other ultra-short-term bond fund, or 2) keeping up to 1% of assets in reserve and holding back 3% of investors' assets for 30 days when they make withdrawals. When three of the five SEC commissioners declined to sign on, she criticized their decision in a [public statement](#), which provoked sharp responses from her colleagues ([here](#) and [here](#)). In a clear invitation to federal banking regulators, Schapiro wrote:

Other policymakers now have clarity that the SEC will not act to issue a money market fund reform proposal and can take this into account in deciding what steps should be taken to address this issue.

But Geithner is not letting her off the hook. He has [asked the FSOC](#) to make a formal recommendation to the SEC to go back to work. He wants the FSOC to tell the SEC to propose at least three MMF reforms: Schapiro's two proposals cited above plus a third under which MMFs would be subject to "liquidity and enhanced capital standards, potentially coupled with liquidity fees or temporary 'gates' on redemptions."

In the event that the SEC does not get the message, Geithner also asked the FSOC to initiate parallel proceedings to declare MMFs to be SIFIs, though the FSOC's authority to do so is questionable. It may hesitate to court a legal showdown this early in its tenure. As a last resort, Geithner threatened to use banking regulators' existing powers to beat MMFs into submission, such as by banning them from tri-party repo transactions involving banks.

The same day that Geithner sent his letter, SEC commissioner Daniel Gallagher stated in an interview that the floating NAV "[is an attractive option that I am likely to support](#)." This seems a reversal of his [August position](#) that Schapiro's proposals:

were not supported by the requisite data and analysis, were unlikely to be effective in achieving their primary purpose, and would impose significant costs on issuers and investors while potentially introducing new risks into the nation's financial system.

He has not said whether he would now provide the third vote for Schapiro's proposal.

#### **The Next Step**

[Some speculate](#) that the Geithner letter and Gallagher switch will lead to a rule proposal, but the next step is more likely to be a request for information. Gallagher might not wish to flatly contradict his position that Schapiro's rule amendments "were not supported by the requisite data and analysis" and simply proposing them "could have harmful consequences." Also, collecting more data might temper increasing concerns in Congress, where [criticism of SEC cost-benefit analysis](#) has been heated, while also improving the SEC's chances of surviving an inevitable legal challenge from the MMF industry. The SEC's [recent record in such court challenges](#) has been abysmal.

Commissioner Luis Aguilar [supports issuing a request for information](#), though he might be less cooperative after having been thrown under the bus for opposing Schapiro's proposal. After *The New York Times* [excoriated him](#) for opposing Schapiro's plan, a popular blog reported that the "[industry got to him](#)" and called for "replacing turncoat regulators" as a "top priority" for President Obama.

Ironically, Aguilar has actually been the current SEC's strongest investor advocate. Indeed, he was the lone opponent of Schapiro's [recent proposal](#) to allow hedge funds (including unregulated MMF surrogates) to publicly offer their shares without complying with *any* of the investor protections that apply to MMFs. Even Geithner conceded in his letter that the SEC must consider the potential for MMF reforms to drive cash to "unregulated cash-management products."

The risks of MMF money flowing to hedge funds will only increase because the SEC's proposal will allow them to engage in public advertising. The SEC has taken the position that it is not required to consider the increased retail investor risk created by letting hedge funds loose in the mutual fund space. However, it now may find it necessary to consider the systemic risk of its hedge fund advertising proposal if it expects its MMF reforms to survive.

The shoe yet to drop is the systemic risk created by driving MMF cash to *banks*, rather than to hedge funds. Placing additional burdens on MMFs will undoubtedly drive more cash to banks, over 3,000 of which have failed (compared with one retail MMF) since MMFs were first offered. Contrary to popular belief, banks pose risks for savers. Just ask retail depositors in the failed--but "insured"--[IndyMac Bank who lost about 50% of their deposits above \\$100,000](#). They would have been far better off with a 1% loss in the Reserve Fund--*which lost more money than any MMF in history*.

Geithner wants the FSOC to focus on MMFs when it [has not even gotten around to declaring](#) [American International Group \(AIG\)](#)--the archetype of too-big-to-fail systemic risk--to be a SIFI. He sees a huge threat in virtually risk-free MMFs while proposing no steps to deal with the fact that four firms--[Bank of America \(BAC\)](#), [Wells Fargo \(WFC\)](#), [Citigroup \(C\)](#), and [J.P. Morgan Chase \(JPM\)](#)--control [more than half of all bank holding company assets](#).

It is banks, not MMFs, that are the epitome of the moral hazard model we should be devising ways to dismantle, not encourage. The Dodd-Frank Act increased moral hazard by raising the insured deposit limit from \$100,000 to \$250,000 ([non-interest-bearing accounts still have unlimited insurance](#)), while doing nothing to shrink too-big-to-fail banks. The hard question that the SEC should tackle, but that it is likely to dodge, is whether driving MMF assets to banks would create more systemic risk, not less.

#### **The Ideological Divide**

The MMF battle reflects the economist's conceit that fixing the last crisis is simply a matter of finding the right formula. [Basel III](#) will correct the deficiencies of Basel II. The [Volcker rule](#) will prevent speculative trading. The Titanic will never sink. And

Schapiro's 1% capital reserve coupled with a 3% redemption holdback will prevent another run on MMFs. No matter that a [Fed study](#) found that past bailouts of MMFs have exceeded 6% of assets. After the next run, we will simply increase the reserve requirement to 7%.

The ultimate solution to panics such as the MMF run of 2008 has been the same as long as governments have coined money. Restoring confidence during financial panics requires a reliable source of infinite liquidity. Currently, the markets believe that the Fed has infinite liquidity (which depends entirely on the [strange loop](#) of our believing that it does).

Yet it appears that the only regulatory model under which banking regulators can imagine resorting to the promise of infinite liquidity is their own, where taxpayer-guaranteed deposits are invested by banks in illiquid, long-term, risky assets. Notwithstanding the extraordinary safety record compiled by MMFs investing in liquid, short-term, safe assets--backed by only an implicit government guarantee--banking regulators are only able to see the Reserve Fund's failure and the MMF run that it triggered. MMFs' short-term asset structure has proved to be a better, safer way to manage government-backstopped cash accounts than banks' long-term asset structure.

The MMF battle embodies the central ideological divide in financial-services regulation. Banking regulation promotes the socialization of risk and thrives on secrecy. Securities regulation promotes the decentralization of risk and thrives on disclosure. Banking regulation places the highest value on a communitarian ethic of systemic safety and soundness, whereas securities regulation exalts an individualistic ethic of risk and reward. Banking regulation fosters the expansion of government power while securities regulation inevitably weakens it. These are the battle lines in the fight over the future of MMFs.

Mercer Bullard is president and founder of [Fund Democracy](#), a mutual fund shareholder advocacy organization, an associate professor of law at the University of Mississippi School of Law, a senior adviser for financial planning firm Plancorp Inc., and a former assistant chief counsel at the Securities and Exchange Commission. He has testified frequently before Congress on regulatory issues. He can be reached at [bullardm@funddemocracy.com](mailto:bullardm@funddemocracy.com).





**Delivered to the Staff of the  
Securities and Exchange Commission  
September 6, 2017**

## **Request for Guidance Related to Disclosure of BDC Expenses by Acquiring Funds**

The purpose of this paper is to request guidance from the Securities and Exchange Commission's Division of Investment Management related to disclosure requirements that inadvertently cause potentially misleading and inaccurate disclosures of fees by mutual funds and other registered funds when those funds invest in publicly traded business development companies ("BDCs"). The issue arises in the context of amendments to investment company registration forms adopted by the SEC in 2006.<sup>1</sup> The amendments require each fund registered under the 1940 Act to include in its prospectus fee table its *pro rata* share of any expenses of the shares it has purchased of another fund. These "acquired fund fees and expenses" (commonly referred to as "AFFE") are included as a separate line item in the acquiring fund's fee table.

The application of this disclosure requirement to BDCs distorts and overstates the expenses of mutual funds and other registered funds when those funds invest in BDCs. We request that the SEC staff treat BDCs like similar investment vehicles and issue guidance stating that the AFFE requirement does not apply to investments in BDCs. The guidance can be issued quickly and efficiently in the form of an FAQ, which we propose at the end of this paper.

Neither the proposing release nor the adopting release for the AFFE rule made any reference to the AFFE disclosure applying to a registered fund's purchase of shares of a BDC. We understand that, after the fact, the staff applied the AFFE rule to BDCs, but the staff did so

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<sup>1</sup> See Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006), available at: <http://www.sec.gov/rules/final/2006/33-8713.pdf>.

without providing any robust explanation or justification for their inclusion and despite the fact that the staff did not apply AFFE disclosure to very similar investment products, such as real estate investment companies (“REITs”). More importantly, the staff applied the AFFE rule relating to BDCs without considering the effect of such application on investors or the BDC market.

The application of the AFFE rule to BDCs has resulted in grossly overstated expenses of funds that invest in BDCs, and as a result, misleading information is being disseminated to fund shareholders. This is because, as we explain in more detail below, the fees and expenses of BDCs already are reflected in the share price of the BDC. Adding those fees to fund disclosures double-counts those fees. To make matters much worse, the AFFE disclosure has resulted in an effective ban on BDCs from most indices. This consequently has restricted the market for BDCs, has limited institutional ownership of BDCs and has reduced investor choice for these beneficial investment options.

We urge the staff of the Division of Investment Management to issue guidance, like it has done for REITs and other similar investment products, clarifying that the AFFE rule does not apply to investments in BDCs. The guidance will result in more accurate expense information being provided to investors. It also will help attract institutional ownership of BDCs. This will benefit investors and the capital markets by allowing BDCs to provide greater support for capital formation and capital deployment to lower and middle-market companies. It also will promote beneficial corporate governance practices.

Below we explain the benefits BDCs provide to investors and the markets. We then summarize the SEC’s stated policy goals for adopting the AFFE rule and we explain, in light of these goals, the policy rationale for excluding BDCs from the AFFE disclosure. We also explain

the harm that the AFFE rule has caused to constituents in the BDC marketplace. Finally, we provide recommended language for staff guidance to remove BDCs from the AFFE rule disclosure requirement.

**1. BDCs Benefit the U.S. Economy and Investors**

Congress established BDCs in 1980 to make capital available to small, developing, and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing.<sup>2</sup> BDCs must invest a certain amount of their assets in eligible portfolio companies, typically US issuers that are either privately owned or have less than \$250 million in market capitalization.<sup>3</sup>

While not limited to debt investments, BDCs' primary role in the economy to date has been to provide debt financing to companies, primarily in the small and middle-markets, that may find it difficult to obtain traditional bank financing. These small and medium sized businesses are vital to promoting job formation and growth of the U.S. economy as a whole.

This role has only increased in recent years as banks have pulled back from middle-market lending in the face of stricter post-financial-crisis capital requirements. As their statutory mandate contemplated, BDCs have sought to expand their role and fill this void. They have had some success, managing over \$50 billion as of April 1, 2017, while the number of publicly-traded BDCs has grown to more than 50 as of that same date. A supportive equity market, in the form of access to retail and institutional investors, is critical to fully realize Congress's goal in

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<sup>2</sup> Small Business Investment Incentive Act of 1980, H.R. 7554, 96th Cong. (1980), amending the Investment Company Act of 1940.

<sup>3</sup> U.S. Securities and Exchange Commission, "Definition of Eligible Portfolio Company under the Investment Company Act of 1940, Amendments to Rule 2a-46" (May 15, 2008).

creating BDCs, and the staff's application of the AFFE rule has inadvertently limited BDCs' potential to do just that.

To give just one example, Ares Capital Corporation ("Ares"), invested in OTG Management, Inc. ("OTG"), a founder-owned operator of full service sit-down and quick service restaurants, bars, lounges, gourmet markets, and news and gift shops in U.S. and Canadian airports. OTG had been awarded a contract to build and operate the food and beverage concessions at the new Terminal 5 at New York's JFK International Airport. As a small company with limited operating history, OTG had been unable to obtain financing from traditional lenders. Ares stepped in to provide OTG with much-needed capital, as well as management expertise and support, to assist OTG in continuing to grow its business. BDCs have the potential to create far more success stories, like OTG's, but the AFFE rule is hampering their ability to do so.

In addition to their unique and valuable capital formation role, investments in BDCs provide many benefits to investors. Investors frequently find BDCs to be attractive and diversified investments, particularly in the current low interest rate environment. BDCs provide access to an asset class typically only accessible to institutional and wealthy investors through private funds, and they provide access to such investments in a liquid structure through exchange traded shares. BDCs pay out strong dividends, making them attractive to income-seeking investors, such as retirees. And they accomplish this in an efficient, flow-through tax structure.

## **2. The SEC's Policy Rationale for Adopting the AFFE Rule Does not Apply to BDCs**

When adopting the AFFE rule, the SEC stated that its primary goal was to provide investors with a greater understanding of the actual costs of investing in a fund whose investments included shares of other "traditional investment funds," as some of those other funds

have their own expenses that may be equal to or higher than the acquiring fund. The SEC further stated that the disclosure requirement would allow investors to compare their investment opportunities, such as investing in alternative funds of funds or traditional funds.

The SEC's policy goals do not apply to the operational expenses of a BDC. AFFE disclosure regarding investments in BDCs misleads investors – it does not provide them greater understanding about the cost of investing in funds that invest in BDCs. And AFFE rule disclosure relating to BDCs does not result in an investor's ability to compare investment opportunities. Instead, the AFFE rule requires a double-counting of BDC operating expenses.

**a. BDC “fees” are just like an operating company's expenses**

At the heart of the issue is a need to avoid confusing the fees of a BDC, which is not a traditional investment fund, with the expenses of a mutual fund or other traditional investment fund. The fees of a BDC are a component of its operating costs, like the compensation expense of traditional operating companies which is not required to be included under the AFFE rule disclosure requirements.

BDCs are registered under the Securities Act of 1933 and the Securities Exchange Act of 1934, and are subject to all registration and reporting requirements under those two statutes. Similar to other operating companies, BDCs must file periodic reports, including Form 10-Ks and, Form 10-Qs, which include the BDC's statement of operations and other financial statements. A BDC's fees are reported on its statement of operations as expenses. These expenses include compensation, real estate and other operating expenses. The statements of operations calculates a BDC's net investment income as the difference in revenues minus these operating expenses. The BDC's net asset value (NAV) is reported on the statements of assets

and liabilities and is calculated as total assets minus total liabilities. The information reported on these financial statements have a direct influence on a BDC's trading price.

A BDC's fees and expenses, furthermore, are not direct costs paid by the acquiring fund's shareholder. They are not used to calculate the acquiring fund's net asset value. They have no impact on the costs associated with the operations of the acquiring fund. They also are not included in the acquiring fund's financial statements, which provide a clearer picture of the acquiring fund's actual operating costs.

**b. The AFFE rule requires a double-counting of a BDC's expenses and results in misleading disclosure**

Long-established, traditional valuation techniques dictate estimating a firm's intrinsic value by valuing the assets in its portfolio. The typical approach is to conduct a discounted cash flow analysis to value all the assets in the portfolio. As outlined by one of the foremost authorities on valuation, Gaughan et al., "The discounted future cash flows approach to valuing a business is based on projecting the magnitude of the future monetary benefits that a business will generate."<sup>4</sup> The earnings or cash flows for each asset, which are calculated net of expenses, are discounted back to present value to determine the intrinsic value of the firm. Public share prices reflect a firm's intrinsic value. According to Koller et al., another authority on valuation, "Valuation levels for the stock market as a whole clearly reflect the underlying fundamental performance of companies in the real economy. . . . Our studies indicate that, in most cases and

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<sup>4</sup> Patrick A. Gaughan "Valuation" in *Mergers, Acquisitions, and Corporate Restructurings* (Hoboken, NJ: John Wiley & Sons, Inc., 2007) p. 535.

nearly all the time, managers can safely assume that share prices reflect the markets' best estimate for intrinsic value."<sup>5</sup>

When an acquiring fund purchases a mutual fund, shares are purchased at the acquired fund's NAV. The NAV reflects the portfolio asset values but does not capitalize the present value of the future management fees, and these future management fees will represent a reduction in the investor's returns. When an acquiring fund purchases a BDC at its market price, however, that price effectively capitalizes future expenses. The BDC's trading price will already reflect its operating expense structure, which in turn will reduce the total return of the acquiring fund's investment in the BDC. Reflecting these expenses again under the AFFE rule results in double-counting a BDC's expenses, and hence the AFFE rule disclosure requirements will result in significantly overstating acquiring fund expense ratios.

Disclosure in a recent Vanguard prospectus illuminates the point.<sup>6</sup> In providing a rationale for an acquiring fund's expense ratio, the prospectus explained, "Like an automaker, retailer, or any other operating company, many BDCs incur expenses such as employee salaries. These costs are not paid directly by a fund that owns shares in a BDC, just as the costs of labor and steel are not paid directly by a fund that owns shares in an automaker."<sup>7</sup> The Vanguard prospectus went on to say that an acquiring fund is nevertheless required to include BDC expenses in an acquiring fund's expense ratio, and to explicitly state that "the expense ratio of a

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<sup>5</sup> Tim Koller, Marc Hoedhart, and David Wessels, "Market Value Tracks Return on Invested Capital and Growth" in *Valuation* (Hoboken, NJ: John Wiley & Sons, Inc., 2010), p. 326.

<sup>6</sup> Vanguard Explorer Value Fund Prospectus, "Plain Talk About Business Development Companies and Acquired Fund Fees and Expenses" (December 22, 2016).

<sup>7</sup> *Id.*

fund that holds a BDC *will thus overstate* what the fund actually spends on portfolio management, administrative services, and other shareholder services by an amount equal to these Acquired Fund Fees and Expenses.<sup>8</sup> As demonstrated by the Vanguard disclosure, including BDC expenses in an acquiring fund's fee ratio overstates the acquiring fund's expenses and provides misleading and inaccurate information to investors.

The Market Vectors BDC Income ETF (Ticker: BIZD), which tracks an index comprised almost entirely of BDCs, provides another example of how the AFFE rule forces an acquiring fund to overstate its expense ratio.<sup>9</sup> As reflected in the ETF's fee table in its most recent prospectus, the ETF's management fee is 0.40%, the ETF's other expenses are 0.18%, while its acquired fund fees and expenses are 8.79%, resulting in a gross operating expense ratio of 9.37%.<sup>10</sup> That number massively overstates the fund's actual gross expenses of 0.53%, as reflected in the ETF's annual report for the fiscal year ended April 30, 2016 (the period reflected in the ETF's fee table). The AFFE rule's applications to investments in BDCs required a dramatically large overstatement of this fund's expenses in its prospectus, and therefore a significant financial disclosure discrepancy.<sup>11</sup>

This example shows the distortion of an acquiring fund's reported expenses when it is required to include BDC expenses in its AFFE rule disclosure, and calls into question the usefulness or validity of such disclosure to acquiring fund shareholders. Another example is the

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<sup>8</sup> *Id.* (emphasis added)

<sup>9</sup> Market Vectors BDC Income ETF Summary Prospectus (September 1, 2016), available at: <https://www.vaneck.com/etf/income/bizd/overview/>

<sup>10</sup> *Id.*

<sup>11</sup> Van Eck Vectors ETF Trust Annual Report (April 30, 2017), available at: <https://www.vaneck.com/etf/income/bizd/overview/>



impact on the Russell 2000 Index. In 2013, before they were removed from that index, BDC's represented roughly 1.2% of the Russell 2000 Index. Though they represented only a very small portion of the index, inclusion of BDCs increased the expense ratio of the overall index by 25% (from 20 to 25 basis points).<sup>12</sup> If operating companies were the subject of AFFE disclosure, they would have a similarly distortive effect.

**c. The staff should treat BDCs the same as REITs and certain other non-traditional investment vehicles for purposes of the AFFE rule**

BDCs operate almost entirely the same way as REITs. This makes sense because BDCs essentially modeled themselves structurally after REITs. Like REITs, BDCs operate a portfolio of financial assets (loans for BDCs, real estate for REITs) that requires sourcing and managerial expertise. Both REITs and BDCs are characterized as nontraditional investments that are designed to provide yield to investors, they are taxed identically under Subchapter M of the Internal Revenue Code, and, due to these similarities, they are often accepted in the same distribution channels.<sup>13</sup>

The AFFE rule is not applied to an acquiring fund's investment in securities issued by REITs, even though their fee and expense structures are materially identical to BDCs. We know of no sound policy rationale for treating REITs and BDCs differently for purposes of the AFFE rule—both should be excluded because they function like operating companies, not traditional investment vehicles that were at the heart of the SEC's policy rationale for the requirement.

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<sup>12</sup> Wells Fargo Securities Equity Research, "The IQ17 BDC Scorecard" (January 18, 2017).

<sup>13</sup> See Cynthia M. Krus, Esq. and Owen J. Pinkerton, Esq., "How Are REITs and BDCs Different?" FYI: Timely Insights by the Real Estate Investment Securities Association (REISA) (August 2012 Vol. 7, Issue 3). *available at*: <https://www.adisa.org/MediaLibraries/REISA/Images/.../FYI-August2012.pdf>

Almost immediately after adoption, the AFFE rule caused some confusion as to whether it applied to certain investments other than mutual funds and other traditional investment vehicles. Like our request for BDCs, other non-traditional investment vehicles have sought and obtained guidance that the AFFE rule does not apply to investments in them. The Investment Management Division issued FAQs discussing the disclosure of fund of fund expenses by mutual funds.<sup>14</sup> In response to “Question 1” of the FAQs, for example, the staff stated that requirements of the AFFE rule were not applicable to “collateralized debt obligations [“CLOs”], or other entities not traditionally considered pooled investment vehicles.” The structure of CLOs are similar to that of BDCs in many ways. Like BDCs, CLOs are comprised of loan assets and distribute substantially all of their interest income from the such loans to investors. Despite the similar business models of CLOs and BDCs, BDCs were not included in the exception provided to CLOs in Question 1 of the AFFE FAQ.

**d. There is no evidence that the SEC intended to apply the AFFE rule to investments in BDCs**

We believe that BDCs never were the intended target of the SEC’s AFFE rule. At the time the AFFE rule was proposed, the BDC market was exceptionally small –there were only five significantly sized BDCs in 2003, when the SEC proposed the AFFE rule. In 2003, BDC assets under management were less than \$5 billion, but they have grown to over \$50 billion in 2017. This likely explains why the SEC did not analyze the impact on BDCs and why the limited number of BDCs in existence at the time failed to provide any comments on the rule

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<sup>14</sup> SEC Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses (last modified May 23, 2007), available at: <https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>.

proposal.<sup>15</sup> There appears to have been little understanding of the implications of the AFFE rule on BDCs because the BDC marketplace was new and the impact of the rule on BDCs was not yet clear. BDCs might have commented if they had understood that the rule would be an effective ban on BDCs from most indices.

Regulatory agencies have been directed by executive order to revisit and revise regulations that are unnecessary or ineffective, that eliminate jobs or inhibit job creation, or that impose costs that exceed benefits.<sup>16</sup> The application of the AFFE rule to BDC investments meets all these criteria.

### **3. The AFFE Rule Has Reduced BDC Access to Capital and Liquidity**

The AFFE rule's application to BDCs has created significant problems for BDCs in the capital markets and specifically has resulted in a substantial decline in institutional ownership.

First, the inclusion of BDC expenses in an acquiring fund's AFFE rule disclosure has negatively affected traditional institutional investment in BDCs (primarily mutual fund investments) due to the unnecessary consolidation of all the expenses of a BDC investment into the acquiring fund's expense ratio. This makes it very challenging in a competitive mutual fund environment for portfolio managers to consider investments in BDCs because a large emphasis is placed on reported mutual fund expenses.<sup>17</sup>

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<sup>15</sup> Comments on Proposed Rule: Fund of Funds Investments *available at*: <http://www.sec.gov/rules/proposed/s71803.shtml>.

<sup>16</sup> Presidential Executive Order on Enforcing the Regulatory Reform Agenda, Executive Order 13777 (February 24, 2017).

<sup>17</sup> Wall Street Journal, "Fees on Mutual Funds and ETFs Tumble Toward Zero" (January 26, 2016).

Second, in 2014 the MSCI, Russell and S&P indices all removed BDCs from their respective indices primarily because of the AFFE rule disclosure requirement.<sup>18</sup> In all, the decisions by these index providers affected more than 30 BDCs, and BDC index performance in 2014 showed a negative result.<sup>19</sup> The removal of BDCs from these prominent indices has further reduced institutional share ownership in BDCs which has resulted in reduced BDC share liquidity and increased capital raising costs. Access to the capital markets is of particular importance for BDCs, because they are limited in their ability to retain capital. This is because BDCs are required to distribute a minimum of 90% of their taxable earnings annually and, as a practice, they typically pay out dividends at a relatively stable level.

The impact on the total number of public BDCs and their assets under management (“AUM”) as a result of their removal from the MSCI, Russell and S&P indices in 2014 is palpable, as the chart included as Attachment A shows. The steady growth in the number of public BDCs for more than a decade prior to 2014 has flattened since that time. In addition, the chart also shows that while AUM grew rapidly starting in 2010, it has declined during the last two years.

After the exclusion of BDCs from the MSCI, Russell and S&P indices, institutional ownership of BDCs also declined significantly. Earlier this year, one of the most respected research analysts on the BDC sector examined voting participation rates in BDCs and concluded that retail shareholders get better governance from the BDCs they’re invested in when the BDCs

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<sup>18</sup> See Removal of BDCs from Indices May Reduce Equity Access, Fitch Ratings (March 13, 2014) available at: [https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Removal-of-BDCs?pr\\_id=823651](https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Removal-of-BDCs?pr_id=823651).

<sup>19</sup> CEFA’s Closed-End Fund Universe (December 31, 2014).

have strong/significant institutional ownership.<sup>20</sup> Conversely, governance suffers when institutional ownership is lower. Institutional investment is imperative for providing access to capital for BDCs, which in turn supports the liquidity of BDC shares, leads to improved corporate governance, and provides greater protection for all BDC shareholders, both retail and institutional.

**4. The Staff Should Amend the AFFEs Rule FAQ to Exclude BDCs**

The most efficient and direct way to remedy the disparate treatment of BDCs is simply to amend the AFFEs Rule FAQs to exclude BDCs. Our proposed AFFEs Rule FAQ is as follows:

**Question 9**

**Q:** Although REITs are not excluded from the definition of “investment company” under sections 3(c)(1) and 3(c)(7) of the Investment Company Act, and are instead excluded under section 3(c)(5), AFFE disclosure requirements do not apply to REITs. Like REITs, BDCs operate a portfolio of financial assets (loans for BDCs, real estate for REITs) that requires sourcing and managerial expertise, and their fees and expenses are materially identical to those of REITs. Does instruction 3(f)(i) to Item 3 of Form N1-A require an Acquiring Fund to disclose fees and expenses associated with investments in BDCs?

**A:** No. Like REITs, BDCs are not considered to be traditional pooled investment vehicles of the type targeted by the AFFE disclosure requirements.

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<sup>20</sup> Wells Fargo Securities Equity Research, “The IQ17 BDC Scorecard” (January 18, 2017) (“lower institutional ownership led to a much less engaged shareholder base, which, in turn, led to much less corporate governance on behalf of retail investors. . . . Large institutional investors are often much better about actively vetting corporate/board proposals.”)



**WRITTEN STATEMENT FOR THE RECORD**

**FOR THE HEARING ENTITLED  
"LEGISLATIVE PROPOSALS TO IMPROVE SMALL BUSINESSES'  
AND COMMUNITIES' ACCESS TO CAPITAL"**

**UNITED STATES HOUSE COMMITTEE ON FINANCIAL SERVICES  
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND INVESTMENT**

**3 NOVEMBER 2017**

**SUBMITTED BY THE COALITION FOR SMALL BUSINESS GROWTH**

Chairman Huizenga, Ranking Member Maloney, Members of the Subcommittee,

The Coalition for Small Business Growth (CSBG) thanks you for the opportunity to submit this written statement for the record for the 3 November 2017 hearing before the House Financial Services Committee entitled, "Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital." CSBG is a national advocacy group composed of small business, financial institutions and law firms from around the country focused on protecting and expanding access to capital for small and mid-sized businesses in the U.S.

Today's hearing comes at a critical time for America's Main Street businesses. In the aftermath of the financial crisis of 2008, large banks have retrenched from lending to small businesses. Stunningly, according to the Wall Street Journal, small business lending from the 10 largest banks collectively decreased 38% from 2006 to 2014,<sup>1</sup> while those institutions continued to grow in asset size. Fortunately, America's small businesses have had other options to keep them afloat and grow: business development companies (BDCs).

BDCs are closed-end funds that provide capital to small- and middle-market companies, while allowing ordinary investors to finance startups – effectively "Main Street funding Main Street." Congress created BDCs in 1980 following a period of economic turmoil similar to the Great Recession. BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to access capital from traditional

<sup>1</sup> <https://www.wsj.com/articles/big-banks-cut-back-on-small-business-1448586637>

sources, such as banks. Importantly, a BDC is required by law to offer “significant managerial assistance” to any portfolio company invested in eligible assets.<sup>2</sup> They are also regulated by the Securities and Exchange Commission under the Investment Company Act of 1940, and publicly-traded BDCs are subject to the disclosure requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. Despite an outdated regulatory regime that is now more than 36 years old, BDCs have managed to provide over \$87 billion in investment capital to America’s entrepreneurs and have evolved into a primary source of Main Street financing. This growth accelerated following the economic downturn after the recent financial crisis, where BDCs addressed the needs of companies starved for capital. Currently, there are over 80 BDCs in the United States and, at a time when bank lending has scaled back significantly, BDC loan balances have more than tripled since 2008.

While BDCs have attempted to fill the financing gap, there are nearly 200,000 middle market businesses that represent one-third of private sector GDP, employing approximately 47.9 million people<sup>3</sup> eager for capital to grow, hire, and expand the economy. With the appropriate modernization of the outdated regulatory regime with common sense changes, Congress can help BDCs continue to fund America’s entrepreneurs.

#### *Reform of Asset Coverage Test*

The first modest change Congress can make to help unleash lending to small businesses is to update the asset coverage test. Today, while BDCs often take the place of banks in filling the void in lending to small businesses, they are subject to much more restrictive asset coverage rules than banks. Specifically, BDCs are not permitted to borrow more than \$1 for every dollar of assets they own, while banks are permitted to borrow up to \$10 (or more), and small business investment companies (SBICs)—which function similarly to BDCs—are allowed to borrow \$2.

While being allowed to maintain a 1:1 debt to equity ratio, currently most BDCs maintain an average leverage ratio of 0.5x-0.75x, reflecting a desire and a practical need to maintain an adequate cushion in the unprecedented, unlikely event of a sudden and steep drop in asset values. This practice is driven in part by the requirement that BDCs “mark-to market” the value of their portfolio companies, which can erode the fair market value of a BDC’s holdings due to negative changes in the broader loan market, irrespective of the actual financial performance of such portfolio companies. The maintenance of this cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress to increase capital to small- and medium-sized businesses.

To solve these problems we encourage Congress to enact a modest increase in the BDC asset coverage test from a 1:1 to a 2:1 debt to equity ratio, thereby allowing BDCs to increase their lending to small businesses while allowing them to simultaneously decrease their risk-profiles by allowing BDCs to invest in lower-yielding, lower-risk assets that don’t currently fit their economic model. We believe that this proposed change will benefit borrowers through greater

<sup>2</sup> See Investment Company Act, 15 U.S.C. §2(a) 47 – 48.

<sup>3</sup> [http://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2016-Q4/FullReport/NCMM\\_MMI\\_Q4\\_2016\\_web.pdf](http://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2016-Q4/FullReport/NCMM_MMI_Q4_2016_web.pdf)

financing alternatives and a reduced cost of capital, and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios.

Because BDCs are already required to file quarterly valuations of their portfolios, and are subject to very strict Securities and Exchange Commission (SEC) reporting and disclosure rules, if BDCs were provided additional leverage, shareholders would be fully informed and safeguarded from any additional risk.

As an additional investor protection, we would propose significant safeguards for accessing additional leverage, including (i) a shareholder vote or (ii) an independent board of director vote with a 12 month "cooling off" period. These protections will ensure that a BDC's shareholders will be able to decide whether they want to continue to hold shares of a BDC that plans to access additional leverage.

#### *Offering Reform*

Second, while Congress has streamlined burdensome reporting and disclosure requirements for small operating companies, it has not extended this regulatory relief to their BDC business partners. Despite having developed into a mature and trusted lending sector, BDCs are required to file lengthy, duplicative SEC statements and wait for the SEC to review them. Many companies, including BDCs, often have a very narrow window in which to access the capital markets. Access to this streamlined reporting and registration process under the federal securities laws, where the information included in a company's periodic reports is integrated seamlessly into a registration statement, would enable BDCs to more efficiently access the capital markets, thereby enabling BDCs to bring this capital more quickly to small and medium-sized businesses.

BDCs and other operating companies are subject to generally the same disclosure regimes. To the extent that other types of operating companies are eligible to be well known seasoned issuers (WKSI), we urge Congress to create parity among all operating companies, including BDCs, to be WKSI-eligible. We would further request Congress direct the Commission to amend a series of rules so that BDCs have access to safe harbors available to other operating companies under Rules 168 and 169, Rules 163A and 163, Rules 134, 164, 433, 138, and 139. We would further request Congress direct the Commission to amend Rule 415(a)(1)(x) to clarify that BDCs can be "qualified" to register on Form S-3 even if they are required to register on Form N-2. We would also request similar clarifying amendments to Rule 497 effecting BDC usage of shelf registration and changes to Rule 172 so that BDCs may rely on this "access equals delivery" rule. Finally, we urge Congress to direct the Commission to allow BDCs to use incorporation by reference on Form N-2.

#### *Conclusion*

Thank you for your consideration of reforms to help spur small businesses lending. Common-sense reforms to modernize BDC regulations would permit BDCs to continue to fill the capital void for many promising small businesses and expand the amount of critical financing they can



make accessible to America's entrepreneurs and communities that are the engines of U.S. economic growth.

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**Gilbride, Mark**

**From:** Christopher.M.Rosello@wellsfargo.com  
**Sent:** Friday, November 03, 2017 7:21 AM  
**To:** Gilbride, Mark  
**Subject:** RE: Stivers

Mark - below is some clarification from Jonathan.

I wanted to offer some additional color on our "effective leverage" stat in our BDC scorecard as I'm concerned items are being taken grossly out of context.

First, effective leverage should not be confused with financial leverage (which is what the bill discusses). Effective leverage is a look at a global risk profile for a BDC as derived by its asset composition—and not simply the amount of debt on the balance sheet and it's a mistake to assume the two are the same.

For example, my research shows that a BDC who chooses to invest in CLO equity and mezzanine loans today carry a much higher risk level than those BDCs who choose to invest in 1st lien debt. That said, it is much harder for investors to grasp/quantify this point. So, to make this asset composition point more palatable for investors, I simply apply a set of broad assumptions to BDC portfolio composition to assume a level of debt ahead of that investment. This isn't exact and it in no way is a gage of financial leverage being taken on by the BDC. It just shows that BDCs who hold more risky securities are in fact riskier. I could have easily have called this factor asset composition (which I did when I first started) and simply weighted all BDCs by their ownership of 1st lien debt. You might ask why I went the effective leverage route? The reason I altered the factor early on was that asset composition risks went well beyond who had the most senior debt. For example a BDC with a 70% senior debt and 30% sub debt is much less risky than a BDC with 70% senior debt and 30% CLO equity—so I needed a way to help investors distinguish between the two (hence the current scorecard factor).

Also taking a step back, if folks would like to talk about embedded leverage risks with BDCs and pass it off as financial leverage—then those same individuals might want to re-examine all bank / REIT balance sheets—whose leverage levels would skyrocket.

The major point missed here is that investors through this analysis and the BDCs transparency have the actual ability to understand overall asset composition risks in a BDC portfolio. Banks don't offer that transparency. I'll argue REITs do not either. Interestingly enough, because of this factor investors have been rightfully avoiding BDCs with high concentrations of subordinated securities—not because they believe these securities to be highly levered, but because they believe the assets within these funds to be of higher risk. Interestingly, if folks just use this one scorecard factor in a vacuum they miss the fact that the higher effective leverage (i.e. asset composition) goes to lower the BDCs overall scorecard rank (identifying to investors it is more risky)!

Lastly, folks arguing that effective leverage is too high (thus this isn't a reason to look at the bill) miss the fact that increasing the leverage constraint will actually make effective leverage levels FALL, not rise. At current leverage constraints, several BDC managers are actually reaching for risk owning low quality subordinated securities (CLOs/sub debt) to try and hit a yield bogey for investors. With additional financial leverage, BDCs will be able to earn the same net return for investors but do so in a much safer asset class (1st lien debt)—thus effective leverage overall falls. More importantly, to the folks who believe that BDCs will simply lever AND buy risky securities, they are completely missing the point that both the banks and the capital markets several restrict ownership of higher risk securities. Banks don't lend to CLO equity as well as subordinate debt. Moreover, it is very difficult for BDCs that own high amounts of risky securities to issue equity or term debt—just look at TICC!

Institution	Tier 1 Lev	Tier 1 Cap	Texas Ratio	CRE to TRBC	Adj NPAs	Cov Ratio	EIF Ratio	NIM	NCO%	ROAA	ROAE	Loans to Core
American National Bank - Fox Crk	13.47	15.53	3.81	201.33	0.05	17.10	54.52	7.40	-0.02	1.10	12.33	130.56
BLC Community Bank	13.66	17.22	2.92	154.28	0.43	49.97	62.27	3.36	0.00	1.09	12.10	126.50
Choice Bank	10.86	13.55	11.61	279.18	1.10	1.81	47.92	8.40	0.08	1.03	9.54	
East Wisconsin Savings Bank	9.66	18.47	7.24	54.68	0.21	1.86	93.85	2.81	0.00			87.03
First State Bank	12.16	19.55	9.24	123.12	0.85	2.13	69.33	3.26	-0.05	0.75	5.01	56.51
Greenleaf Wayside Bank	9.16	15.53	0.90	89.73	0.80		73.81	9.35	-0.05	0.69	8.61	58.20
The Bank of Koutsouna	19.00	11.44	60.56	278.64	1.65		75.73	3.44	-0.02	0.68	11.20	121.13
West Pointe Bank	16.89	19.85	31.97	234.19			49.11	3.72	-0.08	1.22	6.75	136.88
Wolf River Community Bank	13.07	18.23	5.32	73.79	0.52	2.15	65.18	3.81	0.07	0.91	7.00	84.65



Michael F. Gerber  
 Executive Vice President, Corporate Affairs  
 FS Investments  
 Philadelphia, PA 19112

Honorable Gregory W. Meeks  
 Committee on Financial Services  
 U.S. House of Representatives  
 Washington, DC 20515

#### Responses to November 3, 2017 Questions for the Record

Dear Congressman Meeks,

Thank you for your additional questions the November 3, 2017 Hearing on Legislative Proposals to Improve Small Business' and Communities' Access to Capital. My responses to your questions are set forth below.

1. Mr. Gerber, one of the reasons I have been examining regulatory changes to the BDC asset coverage test is that small businesses, who are the engines of economic growth in my district, have been struggling to access capital ever since the financial crisis in 2008. Opponents of altering the asset coverage test claim this will harm financial stability, even if debt to equity simply increases to 2 to 1, which is significantly lower than leverage at other lenders — like banks, who are 10 to 1 — and the same as SBICS (2 to 1). Can you please explain if and how BDCs can continue to lend safely if they increase their ability to borrow \$2 for every \$1 of equity?

**Answer:**

Increasing BDCs' debt to equity ratio limit from 1:1 to 2:1 is a very moderate increase. Relative to other lenders, such as banks (debt to equity ratio of 8:1 to low-teens)<sup>1</sup> and hedge funds (high-teens to low 20's),<sup>2</sup> BDCs, even at 2:1, would remain the most conservative users of leverage,

<sup>1</sup> United States Federal Deposit Insurance Commission, *Global Capital Index*, (June 2017).

<sup>2</sup> UK Financial Conduct Authority, 2017 Hedge Fund Survey, (2017).

by far, while maintaining the most transparent lending model. BDCs can use this moderate additional leverage to construct safer portfolios for investors. In the current low interest rate environment and under the current 1:1 leverage limitation, BDCs typically choose between two general investment strategies. The first strategy is to seek yield by investing deeper in the capital structure of a portfolio company. Such an approach creates more risk in the event the portfolio company experiences difficulty as there is less capital behind a BDC's investment to absorb potential losses. The second strategy is to accept lower yields by investing higher in the capital structure of a portfolio company. This approach lessens inherent risk given the position of a BDC's investment in the portfolio company's capital structure, but also reduces returns to the BDC's investors. An increase to the permissible debt-to-equity ratio would open up a third option. With slightly more leverage, BDCs could invest in assets higher in the capital structure that generate less yield and apply the additional leverage to this strategy to compensate investors for the lower inherent risk and generate comparable returns. For these reasons, FS strongly supports increasing the BDC debt to equity ratio to 2:1.

2. Another reason I have been supportive of BDCs is the connection to Main Street. Congress created these entities so that non-accredited investors could help finance lending to small and medium-sized businesses. But I understand that some regulatory decisions have mislead investors about BDCs, which may impede interest in investing in BDCs, ultimately depriving these small business lenders of the capacity to fund entrepreneurs. Specifically, the Coalition for Small Business Growth put out a white paper recently on "acquired fund fees and expenses" (AFFE) as it relates to BDCs, noting that "the application of the AFFE rule to BDCs has resulted in grossly overstating expenses of funds that invest in BDCs, and as a result, misleading information is being disseminated to fund shareholders." Further, the white paper notes that the SEC incorrectly applies this to BDCs despite not applying similar requirements to very similar investment products. Mr. Gerber, can you please explain (1) what impact this has on investors seeking to fund BDCs, and (2) whether and how this can be addressed to minimize the ultimate impact on America's small businesses who are seeking investment capital?

**Answer:**

When adopting the AFFE rule, the SEC stated that its primary goal was to provide investors with a greater understanding of the actual costs of investing in a fund whose investments included shares of other "traditional investment funds," as some of those other funds have their own expenses that may be equal to or higher than the acquiring fund. However, the application of the AFFE rule to BDCs has actually distorted investor's understanding of BDC fees, harming investors, the industry, and the small businesses that rely upon BDC's for capital.

Given the capital-intensive nature of sourcing and managing a bespoke portfolio of investments, BDC expense ratios can be high. However, BDCs quarterly report their net asset value

(NAV), which accounts for the fees and expenses associated with managing such a portfolio. This information has a direct impact on a BDC's trading price. When an acquiring fund purchases a BDC at its trading price, that price already reflects the BDC's expense structure. Requiring funds to report BDC expenses again under the AFFE rule is actually misleading to investors because these expenses are already accounted for in the share price. Thus, the AFFE rule results in a double counting of BDC expenses, artificially inflating acquiring fund expense ratios.

The gross overstatement of BDC "fees" as a result of AFFE has reduced institutional investment (primarily by mutual funds) in the industry, as the inflated expense ratios make it difficult for funds to justify BDC holdings. The rule also resulted in the MSCI, Russell and S&P indices removing BDCs from their respective indices, further decreasing institutional investment – reducing BDC share liquidity and increasing the cost of raising capital. The industry's removal from indices has also resulted in less analyst coverage, further decreasing institutional investment and leaving retail investors without high-quality information upon which investment decisions can be made. This reduction of institutional investment has also resulted in a less engaged shareholder base, leading to less corporate governance on behalf of retail investors. Therefore, although the rule was enacted with the best of intentions, which FS supports, in practice AFFE has generally mislead investors regarding BDC "fees" and left investors without the information and mechanisms to make and protect their investment decisions.

If the SEC were to exempt BDCs from AFFE, institutional investment in the industry would no longer be hampered by the misleading effects of the Rule. Mutual funds and ETFs could reasonably justify investing in BDCs to their shareholders, and the return of institutional investment would likely result in a positive feedback loop, resulting in even more institutional investment in the industry. This increased institutional investment and associated analyst coverage would likely result in BDCs being added back to the MSCI, Russell, and S&P indexes. The potential capital infusion to BDCs resulting from this change is significant. In the first two months following the S&P's decision to de-list BDCs, industry shares fell an average of 8.4% relative to a 3.7% decline in the S&P 500.<sup>3</sup> This decrease in share liquidity increased BDC's cost of raising capital, ultimately hampering the ability of BDCs to make investments. Therefore, resolving the AFFE issue for BDCs will increase share liquidity and reduce the cost of raising capital for the industry, allowing the industry to invest more capital into portfolio companies.

Despite the structural and regulatory similarities of REITs and BDCs, AFFE has not been applied to REITs. Thus, there is a logical regulatory precedent for staff at the SEC to follow in providing BDCs with an exemption from AFFE. Through conversations with the SEC Commissioners and Investment Management Division staff, FS believes a formal rulemaking process is unnecessary to provide the necessary relief. Rather, FS believes a series of regulatory options, short of formal rulemaking would be sufficient to remedy this issue. Doing so would not only improve market-

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<sup>3</sup> Fitch Ratings, *Removal of BDC's from Indices May Reduce Equity Access*, [https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Removal-of-BDCs?pr\\_id=823651](https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Removal-of-BDCs?pr_id=823651) (March 13, 2014).

based investor protections for retail investors, but also allow BDCs to invest more capital in America's small businesses.

# Negative Impacts of New US Money Market Fund Regulations on Businesses and Municipalities

September 30, 2017



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A Division of Novartis, Inc.

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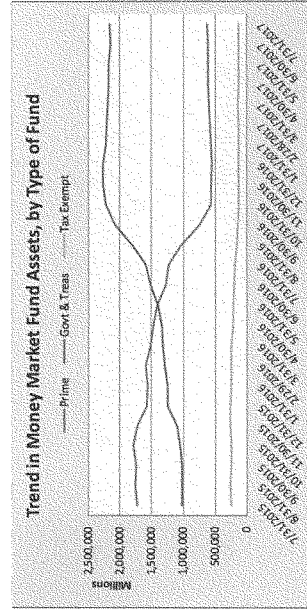
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## Overall Impact of SEC MMF regulations



- Massive flight from Prime and Tax Exempt money funds
  - Prime funds, a key funding source for corporations and banks, fell from \$1.73 trillion to \$0.62 trillion
  - Tax exempt funds, a key funding source for municipalities, universities and hospitals, fell from \$254 billion to \$135 billion
  - In total, \$1.22 trillion has exited Prime and Tax Exempt funds between July 2015 and July 2017
- Municipal borrowers hit with higher rates
- Main street businesses see credit contraction
- Investors see sub par returns



Source: SEC, Treasury Strategies

[www.TreasuryStrategies.com](http://www.TreasuryStrategies.com)

## New Operating Features Made Prime and Tax Exempt Funds Un-useable



Investors forced to abandon Prime and Tax Exempt funds

- Sweep Accounts rendered inoperable by the fluctuating NAV
- Fees, gates and FNAV's not permitted under many corporate investment policies
- Fees, gates and FNAV's not permitted by many loan covenants and bond indentures
- Fees, gates and FNAV's not permitted by most state and local government investment policies.
- Tax and recordkeeping requirements raise operational costs to investors in Prime and Tax Exempt funds.

These structural barriers will prevent much money from ever returning - no matter how wide Prime vs. Government fund spreads, nor how attractive Prime and Tax Exempt rates.

Current Prime vs. Government spreads recently hit 30 bps – double the historic average (cranedata.com) – yet only a few billion of the \$1.2 trillion exodus has trickled back.

TE MMFs exceeded \$500 billion prior to interest rates falling to zero after the financial crisis. Absent the regulations, assets in TE MMFs today would likely be much greater than before rates started to rise.

## Winners and Losers in the Money Fund Rout



### Biggest Winners

#### US Government and Agencies - \$1.2 Trillion

- GSEs such as the Federal Home Loan Bank and Freddie Mac - \$263 Billion
- US Treasury and Repo - \$567 Billion

### Biggest Losers

#### Business and Municipal borrowers - \$1.2 Trillion

- Business borrowers - \$371 Billion
- Municipal borrowers - \$145 Billion
- Financial institutions - \$700+ Billion

#### Investors - \$1.2 Trillion

Winners are rewarded with lower borrowing costs and significantly increased access to credit

Main Street business borrowers get crowded out by large borrowers; pay higher borrowing costs and see more credit limits.

Municipalities maintain credit access but at higher premium to market rates

Investors get 20bps – 30 bps lower rates on Gov't funds, with \$2.5 - \$4 billion in lost income

Note: Large, highly rated corporate borrowers seek credit elsewhere; find it at competitive rates

Source: SEC, Cranedata, Treasury Strategies

[www.TreasuryStrategies.com](http://www.TreasuryStrategies.com)

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## Why Municipalities Pay Higher Rates



Tax Exempt MMFs assets fell from \$254 Billion to \$135 Billion between July 2015 and July 2017, shrinking the funding pool available to municipal borrowers

Primary instruments for municipal borrowing are variable rate demand notes (VRDNs), mainly held by Tax Exempt MMFs. Rates reset weekly or monthly based on the SIFMA index, even though they are long-term instruments.

- **In a radical shift of the supply and demand dynamics, the supply of funds to buy VRDNs fell more than half, yet demand remained constant, which caused rates to rise**
- Some municipalities still have Tax Exempt MMFs owning their VRDNs but now pay substantially higher rates
- The remaining municipalities must resell their notes to other investors at even higher rates
- Municipalities unable to find buyers must put their notes back to a commercial bank, at still higher rates

The lowest municipal borrowing costs are up far more than Fed rate increases

- From January 2016 (nine month prior to the implementation of the SEC regulations) thru Sept. 27 2017, the SIFMA index increased 93bps, from 1 to 94 bps
- Over the same period, Fed Funds rose from 50 to 125 bps - an after-tax increase equal of 45 bps\*

\*Assumes a 40% tax rate: 60% of 75 bps. (125 bps - 50 bps) = 45 bps

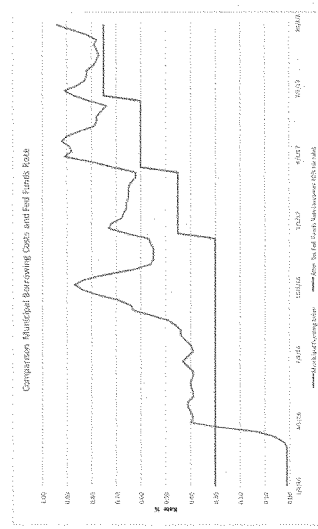
## Why Municipalities Pay Higher Rates



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**Municipalities fortunate enough to continue selling VRNDs to Tax Exempt MMFs saw borrowing costs skyrocket at double the Fed rate increase – 94 bps vs. 45 bps after tax.** For others, the they would have to borrow from other investors or replace the VRDN with bank loans at much higher rates.

Prior to the market adjustments to the new MMF regulations, municipal short term borrowing costs were consistently sell under the after tax Fed Funds rate. Since then, however, municipal costs have been well above the after tax Fed Funds rate.



## How Main Street Borrowers Have Been Crowded Out

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Primary pools of short term capital for U.S. businesses are bank commercial and industrial (C & I) loans and Prime MMFs

- Large firms with top credit ratings borrow from Prime funds
- Small and medium businesses borrow from commercial banks

In July 2015, capital available from these sources was \$2.35 trillion

- Bank C & I loans totaled \$1.89 trillion
- Prime MMFs provided \$460 billion

By July 2017, that capital pool shrank by \$161 billion to \$2.19 trillion, the direct result of investors leaving Prime MMFs.

- Banks C & I loans grew \$210 billion, to \$2.1 trillion
- Prime MMFs funding for businesses shrank by \$371 billion, to \$88 billion

Main street businesses were much more severely impacted by this shift

- Large, highly rated borrowers could replace their Prime MMF debt with bank borrowings
- The \$161 billion shortfall burden fell on the shoulders of main street businesses. They have been crowded out of bank lending sources by the larger companies. Some now pay higher rates to alternative lenders; others may be simply unable to borrow at any competitive rate.

**For each \$1 billion of Prime MMF debt that a large company replaces with bank borrowing, 10,000 main street businesses lose access to \$100,000 in funding.**

# Companies and Municipalities Losing MMF Funding



Companies Experiencing Diminished Money Market Fund Funding (BB) January 2014 – January 2017

Rank	Company	US State	Change in MMF Funding
1	General Electric	HO	(9,398,927,716)
2	Toyota	TX	(7,675,118,979)
3	Coca-Cola Co	GA	(6,301,411,344)
4	Exxon Mobil	TX	(1,721,496,466)
5	Wal-Mart Stores Inc	AR	(1,486,221,550)
6	Nestle	VA	(1,280,893,607)
7	Merit Financial	VA	(1,090,578,800)
8	Republico Inc	NY	(1,081,528,800)
9	Johnson & Johnson	NY	(981,331,697)
10	Johnson & Johnson	NJ	(919,664,902)
11	Chevron Co	CA	(891,831,910)
12	Devon Energy Co	OK	(779,900,000)
13	Procter & Gamble Co	OH	(749,725,812)
14	GlaxoSmithKline	PA	(644,981,295)
15	BHP Billiton	-	(596,029,101)
16	Pfizer Inc	NY	(576,437,747)
17	Comcast Co	PA	(550,085,158)
18	Honda	OH	(475,743,839)
19	BMW	NJ	(428,864,965)
20	Siemens	DC	(330,664,727)
21	Dominion Resources Inc	VA	(326,846,446)
22	Domestic Utilities	VA	(246,854,776)
23	Google Inc	CA	(238,598,140)
24	IBM	NY	(228,319,041)
25	Caterpillar Inc	IL	(218,238,132)
26	Altria Group Inc	VA	(212,948,155)
27	Catholic Health Initiatives	CO	(209,340,368)
28	Deere & Co	IL	(160,988,657)
29	Merck	NJ	(154,841,812)
30	Abbott Laboratories	IL	(138,833,700)
31	El Du Pont De Nemours	DE	(137,979,774)
32	Kimberly-Clark Co	TX	(123,487,295)
33	Army and Air Force Exch	TX	(111,589,836)
34	Unilever	NJ	(100,478,020)
35	Walt Disney Co	CA	(100,000,000)
36	Medtronic Inc	MN	(100,000,000)

States Whose Municipalities Collectively Lost Over \$1B in Funding from Tax Exempt MMFs January 2014 – January 2017

Rank	State	Change in Funding
1	CA	(17,202,647,697)
2	TX	(13,996,372,868)
3	NY	(13,398,460,179)
4	IL	(5,607,365,891)
5	MA	(4,370,357,152)
6	NJ	(3,916,888,439)
7	OH	(3,822,490,622)
8	FL	(3,805,395,018)
9	PA	(3,465,409,956)
10	NC	(3,053,745,477)
11	IN	(2,921,762,474)
12	WI	(2,665,796,950)
13	MI	(2,182,636,426)
14	VA	(2,094,249,275)
15	GA	(2,034,469,395)
16	MD	(1,911,266,987)
17	CO	(1,779,366,964)
18	MN	(1,775,202,506)
19	CT	(1,557,701,346)
20	TN	(1,501,066,293)
21	KY	(1,474,179,464)
22	DC	(1,403,641,709)
23	AZ	(1,397,280,656)
24	VA	(1,383,868,448)
25	LA	(1,272,004,969)
26	OR	(1,162,628,509)
27	SC	(1,138,497,387)
28	UT	(1,053,796,415)
29	NV	(1,023,054,197)
30	NE	(1,009,893,937)

Source: Treasury Strategies and Crane Data

## About Treasury Strategies



Treasury Strategies, a division of Novantas, Inc., is the leading treasury consulting firm. Armed with decades of experience, we've developed solutions and delivered insights on leading practices, treasury operations, technology, and risk management for hundreds of companies around the globe.

We serve corporate treasurers, their financial services providers and technology providers for the complete 360° view of treasury.

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