TESTIMONY OF

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BEFORE THE

HOUSE SUBCOMMITTEE ON CAPITAL MARKETS AND

GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

"LEGISLATION TO FURTHER REDUCE IMPEDIMENTS TO CAPITAL FORMATION"

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I. Introduction

Chairman Garrett, Ranking Member Maloney and members of the Sub-Committee, thank you for the opportunity to testify today. My name is Michael Arougheti and I am the Chief Executive Officer of Ares Capital Corporation, an SEC registered Business Development Company, or "BDC", and one of the largest non-bank providers of capital to small- and medium-sized American companies – the backbone of the U.S. economy. Ares Capital Corporation is publicly-traded on the NASDAQ National Market and is currently the largest BDC by both market capitalization and assets. Since our IPO in 2004 through June 30, 2013, we have invested more than $14 billion in more than 450 small and medium sized American companies, in the process creating tens of thousands of new jobs and providing capital to growing businesses who were unable to access capital through commercial banks or other traditional financing sources.

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". Specifically, after a period of rapid growth, a downturn caused banks to retrench from lending and left small and medium sized businesses with limited options for securing credit. The stated objective of BDCs was to encourage the establishment of new market vehicles to invest in, and increase the flow of capital to, private businesses. By mandate, BDC's are also required to provide managerial assistance to their portfolio companies. Uniquely, the BDC model allows ordinary investors exposure to start-up and small companies – effectively "Main Street funding Main Street".

Today, the middle market employs two out of every three workers in the private sector.[1] Based on data from ADP, small- and medium-sized businesses have lost a combined 843,000 jobs since the beginning of 2008.[2] In contrast, many companies funded by the BDC industry during that same period have been able to increase hiring and grow their respective businesses.

The impact of BDC's on small- and medium-sized businesses has been tangible and meaningful. By way of example, in 2004 Ares Capital Corporation made an initial investment in Reflexite, an employee-owned producer of optical components and films for the Safety, Lighting, Instrumentation and Display markets based in Avon, CT. Reflexite needed to raise capital to, among other things, expand product lines and seed new businesses. However, Reflexite was at a stage in its life cycle where neither a traditional senior debt provider nor a private equity firm was the right fit to provide what Reflexite was looking for. Traditional senior debt providers were not a good fit as their proposed capital was inflexible, they had low tolerance for risk as Reflexite grew new businesses and they could not provide a sufficient amount of capital. Similarly, private equity sources were not a good match as they wanted to be able force liquidity within a certain time frame, which was incompatible with a private company that wished to preserve autonomy and invest in growth over the long term. Because BDCs such as ARCC are "permanent capital" vehicles, they often have a longer investment horizon and can provide more flexible capital to companies like Reflexite. Ares Capital Corporation not only provided capital, but also took seats on Reflexite's board of directors and provided valuable strategic advice and support to the company as it grew.

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[1] Source: ADP National Employment Report – September 2013. Nonfarm private sector employment for companies with 1 to 49 employees and companies with 50 to 499 employees.

[2] Source: ADP National Employment Report – September 2013. Sum of small- and medium- sized businesses. Small businesses defined as less than 50 employees. Medium businesses defined as 50 to 499 employees.

Today there are over 40 publicly-traded BDCs with an aggregate market capitalization of more than $25 billion and approximately $40 billion in assets. While all BDC's do not look alike with respect to criteria such as size of investments, size of portfolio companies and industry focus, all BDCs do share a common investment objective of improving capital access. As traditional lending institutions have been inconsistent in providing loans to small and medium size companies, BDCs now find themselves in a very similar position as they were in 30 years ago – at the forefront of the effort to address the unmet capital needs of small business.

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

II. Policy Challenges / Proposed Policy Solutions

BDCs are heavily regulated and appropriately, the activities of BDCs are fully transparent to regulators, investors and portfolio companies. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. BDC's fall under the supervision of the SEC's Division of Investment Management.

Ironically, many of the challenges faced by BDCs in increasing both the scope of borrowers and the amounts that BDCs can invest arise out of their place in this regulatory framework. Given that BDCs are more akin to operating companies such as banks and other commercial lenders than to mutual funds, BDCs must often play the part of the proverbial "square peg being in a round hole".

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

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

During the "Great Recession", we all learned a number of lessons which hopefully will be taken to heart as the economy continues to improve. One of the important lessons learned by BDCs was that during a downturn, structural constraints in the existing regulatory framework are punitive not only to BDCs but also to the many small and medium sized companies they serve. Three bills have been introduced in the House to modernize the regulatory framework for BDCs

and to mitigate/eliminate many of the issues faced in 2008, thereby ensuring that BDCs can continue to fulfill their Congressional mandate today and in the future.

The first two, H.R. 31 (Velasquez) and H.R. 1800 (Grimm), relate directly to the issue of capital formation and, ultimately, capital flows to small and medium sized businesses through modest, common sense amendments to the Securities Act of 1933 and the Investment Company Act of 1940. In short, they seek to enable BDC's to "do more" than they are currently able to in terms of the number of companies that they can lend to, the types of investments they can make and the amount of capital that they can raise and deploy.

These two bills contain four nearly identical provisions, which we believe illustrates the significant bipartisan support for these changes.

- **First**, both bills propose an increase in the BDC asset coverage test from 200% to 150%, thereby broadening the universe of potential borrowers that can access loans from a BDC. We do not believe that the proposed change introduces more risk. Rather, it should allow BDC's to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test actually forces BDC's to invest in riskier, higher-yielding securities in order to meet the dividend requirements of their shareholders. This potential "de-risking" is further supported by the strong underlying performance of the loan asset class. For example, during the period from our IPO through June 30, 2013, ARCC's non-accrual rate on first lien senior secured loans was 0.8% while the average default rate of the S&P LSTA Leveraged Loan Index for first lien senior secured loans for that same period was 2.49%.[3] Similarly, since inception BDCs have generated a cumulative gain / loss rate of negative 62 bps, outperforming banks by 186 bps.[4] We believe that this proposed change will benefit borrowers through greater financing alternatives and a reduced cost of capital and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios.

  In addition, this proposed change would apply to BDCs the same leverage ratio as the leverage ratio for Small Business Investment Companies but, unlike SBICs, without putting any government capital at risk. This seems prudent, consistent with other legislation that this sub-committee has passed and, as I noted, benefits both small and medium-sized companies and shareholders without any government or taxpayer subsidy.

  An increase in this ratio will also provide additional "cushion" given the requirement that BDC's must "mark to market" their loans each quarter. Specifically, in the event of falling asset values in the overall market as we saw during the Great Recession, unlike banks and other commercial finance companies BDCs are generally required to write down the value of certain of their otherwise performing assets. Currently, most BDCs have an average leverage ratio of 0.5x-0.75x, reflecting a desire and a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep

[3] Source: S&P LCD data for LSTA Leveraged Loan Index ("LLI"). Calculated as the average of LTM rolling monthly default rates over the period from October 2004 through June 2013.
[4] Source: TPG Specialty Lending: 2013 Wells Fargo BDC Leadership Forum – Rating Agency Concerns about BDCs

drop in asset values. However, the maintenance of such a cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress. This additional cushion would provide BDCs with the ability to deploy more capital in the ordinary course and through market cycles.

This proposed change is extremely modest given that banks customarily incur leverage of 10:1 and greater. Further, contrary to those commentators who would suggest otherwise, a decrease in the asset coverage test will not result in an automatic, immediate increase in risk. BDCs will still need to act prudently for the reasons noted above and the "market", including lenders and debt investors, will ultimately make the determination as to "how much leverage is too much".

Finally, given the transparency required of BDCs in their SEC disclosure documents, shareholders will be clearly informed (as they are now) of the amount of leverage that BDCs can incur and any potential risks to them associated with such leverage. This applies equally to retail investors as well as institutional investors, who comprise approximately 40% of BDC shareholders.[5]

- **Second**, both bills would allow BDCs to treat preferred stock as equity rather than as debt and eliminate the requirement that holders of preferred stock have board representation. Many BDCs were challenged during the last downturn, in particular with respect to issuing common equity at a price below net asset value. Had BDCs been able to raise capital during the post 2008 period by issuing preferred shares as equity, many more loans could have been made to cash-starved companies to enable them to retain employees and, in some instances, to remain in business.

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

- **Fourth**, both bills would allow BDCs to own registered investment advisers, which as a technical matter is currently prohibited under the 1940 Act. Apart from viewing these as attractive investment opportunities, investments in RIAs enable money to be raised from third party investors which, in turn, can be deployed to small and medium-sized companies. Under prior rules, an investment adviser did not have to register if it had less than 15 clients and, accordingly, it could be owned by a BDC. The recent removal of this exemption, without any corresponding rulemaking to address the technical glitch caused by such removal, has left BDCs in the uncomfortable position of (1) simply not investing in RIAs at all or (2) for BDCs with existing RIA subsidiaries or portfolio companies, engaging in a fire sale if the SEC doesn't grant permission for such BDCs to continue

[5] Source: Wells Fargo BDC Leadership Forum materials.

ownership of an RIA post-registration. Currently the SEC has been granting exemptive relief from this rule on a case by case basis; this amendment will eliminate this often lengthy and expensive process.

The modest asset coverage ratio increase and change in treatment of preferred stock contained in both H.R. 31 and H.R. 1800, would become effective immediately upon passage. The other provisions will require action by the SEC. Accordingly, we would urge the Sub-Committee to work with the SEC to make these proposed changes in a timely manner.

Last but not least, H.R. 1973 introduced by Congressman Mulvaney, offers welcome flexibility for BDC investment in financial institutions currently limited by the 30% basket. For example, a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context feels quite arbitrary.

III. <u>Closing Remarks</u>

In conclusion, we believe that the time is right to modernize the BDC sector and pass legislation which would allow BDC's to increase capital flows to America's small and medium size companies, spur economic growth and create. We are encouraged by the bi-partisan focus on this important initiative, and look forward to working with the Committee in moving these bills forward.

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