



**Testimony of Joseph Ferraro,
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before
The House Subcommittee on Capital Markets
and Government Sponsored Enterprises
on
“Reducing Barriers to Capital Formation”**

June 12, 2013

Mr. Chairman and Members of the Committee, thank you for the opportunity to testify today. My name is Joseph Ferraro and I am General Counsel to Prospect Capital Corporation, a leading provider of capital to job-creating small- and medium-sized companies in the United States.

I. Prospect Capital Corporation

Prospect is a publicly-traded business development company. A business development company is a closed-end investment company that focuses on investing in small- and medium-sized private companies rather than large public companies. Our company completed its initial public offering in July 2004, and since then we have invested more than \$5.5 billion in over 175 small- and medium-sized companies. Prospect is a growing company whose operations utilize over 75 employees in 5 locations – New York, Chicago, Houston, San Francisco and Westport, Connecticut.

Prospect invests primarily in first-lien and second-lien senior loans and mezzanine debt, which in some cases include an equity component. Our flexible mandate allows Prospect to provide capital to small- and medium-sized companies for re-financings, leveraged buyouts, acquisitions, recapitalizations, later-stage growth investments, and capital expenditures.

Small- and medium-sized companies use capital from Prospect to expand their businesses, hire workers, construct factories, and achieve other important objectives. Prospect's portfolio is diversified across a wide variety of industries – about 50 in total – including manufacturing, industrials, energy, business services, financial services, food, healthcare, and media. The small- and medium-sized companies we finance employ more than 100,000 American workers in nearly every state in the nation.

From the perspective of our shareholders, our investment objective is to generate both current income and long-term capital appreciation through debt and equity investments.

Prospect seeks to maximize returns and minimize risk for our investors by applying rigorous credit analysis to make and monitor our investments small- and medium-sized companies.

We are proud of our track record supporting scores of small- and medium-sized companies that we have helped grow over time. In the current calendar year we have already closed more than \$1.1 billion of investments, and we have closed about \$3 billion of originations in the past twelve months. Our capital has helped create thousands of American jobs over the years, and our capital is much needed in this critical period of high unemployment and economic uncertainty.

II. Business Development Companies

In 1980, Congress enacted amendments to the Investment Company Act of 1940 authorizing business development companies (BDCs). Congress wanted to facilitate private finance investment at a time when, much like today, bank balance sheets were reeling from a period of economic largesse in the 1970s, and small- and medium-sized American businesses faced limited credit options. In response, Congress authorized a publicly traded, closed-end fund structure, the sole intent of which was to facilitate private finance investment to small- and medium-sized American businesses while offering such homegrown businesses significant guidance and counseling concerning management, operations, business objectives, and policies. Put simply, a BDC is a lender to and investor in small- and medium-sized businesses and has stepped into a role commercial banks have largely abandoned – lending to small- and medium-sized American businesses that might not otherwise obtain financing to grow.

BDCs must invest at least 70% of their assets in so-called “eligible assets.” The most common type of “eligible assets” are private and “micro-cap” public American companies. These investments must be privately negotiated and the BDC is required to offer managerial assistance to these companies in which the BDC invests to meet specific business challenges.

Small- and medium-sized American companies generally face difficulty in meeting their capital needs.

And why is that?

On the one hand, generally such companies are too small to afford the expense of directly accessing the public debt and equity markets. On the other hand, their capital needs are frequently too large to be well served by SBA programs or small community banks. These small- and medium-sized companies generally require \$10 million or more in incremental financing.

Financing these companies requires significant time and energy by the lender or capital provider, including due diligence activities and rigorous credit analysis that have become uneconomical for traditional banks, with transaction sizes that are too small for many other capital providers.

Thus, for small- and medium-sized companies BDCs represent a very important source of capital. Our industry today is composed of about 40 publicly traded BDCs collectively managing \$39.1 billion in assets with an aggregate market capitalization of \$26.4 billion. BDCs have become an integral part of the credit markets. Over the nine-year period from 2004 to 2012, BDCs' total loan balances grew from \$2.4 billion to \$21.8 billion. As a percentage of the leveraged loan market, BDCs today represent about 4.1%, up from 2.2% in 2004. And the companies for which our industry has provided capital employ millions of American workers.

BDCs are heavily regulated. They are public companies that are subject to the Securities Act of 1933 and file an election with the SEC to also become subject to the Investment Company Act of 1940. Thus, BDCs are transparent vehicles both for investors and for small- and medium-sized American companies seeking capital. For example, BDCs file the same periodic reports with the SEC as any other public company, while also being subject to the additional regulatory constraints of the Investment Company Act of 1940.

The shareholders of BDCs, many of them retirees on a fixed income, receive the investor protections of our securities laws while having an opportunity to participate in the types of investments that otherwise are only available to deep-pocket investors through private partnerships. BDCs also offer advantages to the companies that are in need of investment capital to grow. For many of the companies in which a BDC invests, traditional sources of financing like bank lending or public offerings are unavailable. For these companies, BDCs offer an alternative source of capital that is subject to public disclosure and transparency.

In summary, BDCs provide substantial benefits to the American economy, including the opportunity for the investing public to invest in smaller growing businesses and the opportunity for such small- and medium-sized companies to obtain much-needed financing.

III. Common Sense Modernization

Mr. Chairman and Members of the Committee, we believe that modest changes to our securities laws can greatly enhance the benefits offered by BDCs to the American economy and allow BDCs to better serve the capital needs of small- and medium-sized companies. These changes have been recommended by legislation introduced by Representatives Mulvaney (H.R. 1973), Velazquez (H.R. 31) and Grimm (H.R. 1800). Our industry already helps to create many American jobs, and if Congress modernizes some of the rules under which we operate I believe that we will be able to create many, many more.

We appreciate not only the efforts of these Members and those of you who are co-sponsoring their bills, but also this Committee's actions in prior years to modernize the rules under which BDCs must operate. Your bipartisan efforts have made BDCs more efficient and the regulations that we operate under more responsive to the needs of both our investors and the small- and medium-sized companies that we serve. This was true in the "National Securities Markets Improvement Act of 1996" when Congress modified the definition of eligible portfolio company and made other adjustments to the original 1980

law. And it was true in 2004 and 2005 when this Committee moved legislation to further improve the definition of eligible portfolio companies.

Today, I would like to urge the Committee to consider some additional steps that can be taken to help make BDCs even more robust capital providers to small- and medium-sized companies, thereby helping with American job creation in this period of high unemployment. As suggested by the bills I have referenced above, a few modest reforms to our securities laws can help every BDC more effectively achieve their purpose without undermining investor protections.

(1) Further Update the Definition of Eligible Portfolio Company

Registered investment companies are allowed to invest in financial services companies, including community banks, leasing companies, factoring firms, and automobile financing companies. However, as described above, BDCs must invest at least 70% of their assets in “eligible portfolio companies.” When Congress created BDCs, it focused on industry and services, but excluded financial services companies from qualifying as “eligible portfolio companies.” Thus, no more than 30% of a BDC’s assets can be invested in financial companies. This limitation makes no sense decades later given the substantial growth of financial services as a leading job provider in the American economy since 1980. Financial services companies employ millions of American workers and have a capital magnifying effect that results in more capital flowing into small- and medium-sized American businesses.

A policy that limits BDC investments in small- and medium-sized financial services companies runs counter to the objective of helping attract capital for the benefit of small- and medium-sized American companies. In fact, frequently such companies in turn serve the financial services needs of other, smaller companies. For example, we have one company in our portfolio called Nationwide Acceptance. Based in Chicago, Nationwide provides capital to Americans with modest means in order for such individuals to purchase automobiles that those individuals need to get to and from work, drive their children to after-school activities, and pursue their individual transportation freedoms. BDCs should not have limits on providing capital to such important companies. Financial service companies serve a vital role in our economy and should be encouraged, not stifled.

Financial businesses that are subject to the current law limitation are comprised of a wide array of companies: community banks, insurance and reinsurance businesses, asset and investment advisors, real estate businesses, industrial loan companies, consumer financing businesses, credit card receivables companies, business inventory and receivables financing companies, automobile financing businesses, equipment financing businesses, companies making loans to purchase livestock feed and farm products, companies owning or holding oil, gas or mineral leases or royalty interests, and many more. Again, these types of companies amplify the amount of capital made available to small- and medium-sized American businesses and American consumers, thereby helping with economic stimulation and job creation at no cost to the federal government.

The original justification for Congress back in 1980 limiting a BDC's level of investment in financial companies is not clear. I believe that this old part of the law is painfully antiquated and arbitrary. BDC investments in small- to medium-sized American financial services businesses are consistent with the principal purpose for which Congress created BDCs – to provide capital and assistance to small, developing businesses that are seeking to expand and create American jobs.

H.R. 1973, the “Business Development Company Modernization Act”, would eliminate this outdated limitation, bring small- to medium-sized American financial services businesses into the family of “eligible assets,” and by doing so remove an artificial and unnecessary obstacle to their growth and increase the flow of BDC dollars into such new and expanding American businesses.

(2) Update 1940 Act's limitations on owning investment advisors

The Investment Company Act of 1940 prohibits a BDC from acquiring more than 5% of any class of equity securities or more than 10% of the total debt securities of (or invest more than 5% of its assets in) any company that directly or indirectly derives more than 15% of its consolidated gross revenues from securities-related activities including acting as a registered investment advisor. Thus the 1940 Act limits the ability of a BDC to invest in investment advisors.

Prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, an investment adviser having fewer than 15 clients could generally avoid registration under the Investment Advisers Act of 1940, and BDCs could and did invest in unregistered investment advisors. BDCs typically used this flexibility to form and manage captive investment advisors that would manage investments on behalf of third party investors or the BDC itself, permitting stockholders in the BDC to benefit from the stream of advisory fees generated by such investment advisors. Following implementation of the Dodd-Frank Act, which repealed this registration exemption for “private advisers,” BDCs owning (or wishing to acquire) a registered investment adviser must apply to the SEC for exemptive relief. Although the SEC has provided administrative relief from this prohibition through several exemptive relief orders, the process is very time consuming and expensive.

The three pending BDC bills would modernize the statute by repealing this prohibition and end the needless spending of shareholder resources to seek administrative relief. In essence, it simply codifies existing practice, removes unnecessary costs and levels the playing field between those BDCs that have been granted exemptive relief and those that have not. Changing the law here also reflects that asset management companies are no riskier, and arguably less risky, than many other parts of the economy. Such companies also employ plenty of American workers, and their growth should be encouraged rather than discouraged.

(3) Modernize and Re-examine the Restrictions on How BDCs Raise Capital

Both H.R. 1800 and H.R. 31 offer some common sense reforms on how BDCs raise capital in the market. Reducing the cost of raising capital benefits both BDC shareholders and the small- and medium-sized American companies in which they invest.

(A) Shelf Registration Forms

BDCs, like other companies that regularly raise capital through securities issuances, rely on pre-filed “shelf registration” – a securities filing that allows a company to be prepositioned to issue additional securities. Because shelf registrations contain financial information that becomes outdated as companies publicly report their most recent financial information, companies are allowed to incorporate by reference in their shelf registrations subsequent financial reports. However, BDCs are not allowed to take advantage of this common sense approach, and instead we must manually update our shelf registration statements *each time* we report new quarterly information. This slows down the timetable for a BDC to access the capital markets and adds the unnecessary expense of lawyers, accountants and printers to the securities offering process.

Why must BDCs replicate the information in duplicative public filings at needless cost and with no known investor benefit?

Why must we file the electronic equivalent of reams of duplicative paper?

Dr. Seuss’ Lorax famously asked: “who speaks for the trees?” The pending legislative initiatives properly ask: “who speaks for common sense?”

These measures require the SEC to reform the forms and instructions for shelf registrations to treat BDCs like other companies eligible to use shelf registration statements. BDCs currently must copy and paste entire documents over and over again into filings, thereby requiring armies of lawyers, accountants, and printers. Every other type of public company in America has more streamlined rules reflecting the electronic age. BDCs should have access to the same streamlined filing benefits.

(B) Offering Reform

BDCs can only offer additional capital to small- and medium-sized American companies when we can increase our own capital. Our industry is traditionally a frequent issuer of new securities offerings to raise such funds. For example, Prospect has raised some \$2.5 billion since our IPO in 2004 through more than 26 public offerings.

In 2005 the SEC modernized the issuance process for frequent issuers, reducing costs and making the process more efficient. However, BDCs were excluded from these common sense reforms, with a promise that the issue would be revisited. Some eight years later nothing has happened. This situation has not benefited the capital needs of small- and medium-sized companies, nor has it provided any beneficial investor protections. It is time

that our business development companies have the same access to the capital markets as enjoyed by other publicly traded companies.

For example, the offering reforms recognize companies that are “Well-Known Seasoned Issuers” or “WKSIs.” These are companies that generally are frequent issuers in the public markets and have significant market capital size. Generally, WKSIs can take advantage of new, liberalized rules relating to communications with investors and the registration process. Unfortunately BDCs were explicitly excluded from the definition of WKSI without any explanation or rationale.

In fact, BDCs are the only industry disadvantaged by offering reform.

How?

Offering reform allows issuers greater freedom to communicate with prospective purchasers. One such method that is allowed is a recorded electronic road show that is played on a delayed basis. Before offering reform, BDCs and other issuers relied on a series of no-action letters issued by the SEC to use electronic road shows. As part of the reform, the SEC withdrew the electronic road show no-action letters. As a result, BDCs are no longer permitted to use or disseminate recorded copies of electronic road shows and were not made eligible for the new modernized communication rules.

There is no public policy justification for BDCs being left behind when the SEC modernized the rules that govern how companies can raise capital in the public markets, nor to have an otherwise constructive modernization effort inadvertently turn the clock back on our industry.

(C) Other Reforms

H.R. 31 and H.R. 1800 also offer other reforms that can assist BDCs in raising and deploying capital to small- and medium-sized American companies. For example, these bills provide some easing of the leverage limits imposed by the Investment Company Act of 1940 on BDCs. The leverage limitations suggested by these bills remain very conservative but provide more leeway for BDCs to have a greater ratio of debt to asset valuation on their balance sheets. These changes underscore the importance of ensuring that BDCs have adequate access to capital themselves, so they can redeploy funds to support the small- and medium-sized companies that they serve. The proposed leverage limitations are still far more restrictive than what banks and insurance companies are allowed to enjoy.

IV. Conclusion

In conclusion, business development companies are an important source of capital for small- and medium-sized businesses. With some common sense reforms it is possible to increase the capacity of BDCs to offer capital to job-creating American businesses without in any way undermining the strong investor protections afforded by the Investment Company Act of 1940.

We applaud the efforts by Representatives Mulvaney, Grimm, and Velazquez and urge the Committee to act favorably on BDC reform legislation to expand capital access and remove inefficiencies in the current regulatory rules. Our industry and our economy, with its still unacceptably high unemployment rate, require action by the Committee in a manner that I have presented to you today without costing the government and taxpayers a single penny.

Again, I greatly appreciate the opportunity to testify today and would be pleased to answer any questions that you may have.