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TESTIMONY OF

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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.[1]

A Brief History of BDCs

A BDC is a type of closed-end investment fund that was created by Congress through the enactment of the strongly bi-partisan Small Business Investment Incentive Act of 1980.[2] Congress' stated objective in creating BDCs was to encourage the establishment of new capital vehicles that would invest in, and increase the flow of capital to, small and mid-sized companies in the United States.[3] As such, the Investment Company Act of 1940, as amended (the "1940 Act"), generally requires BDCs to invest at least 70% of their total assets in the securities of "eligible portfolio companies," which the 1940 Act generally defines as private U.S. operating companies and public U.S. operating companies with market capitalizations of less than $250 million.[4] Consistent with Congress's goal of providing support to small and mid-sized U.S. companies, the 1940 Act also requires BDCs to make available significant managerial assistance to such portfolio companies.[5] In complying with these regulatory requirements, BDCs provide a significant level of capital and assistance to small and middle market U.S. companies. In fact, today, 93 BDCs from across the industry have more than $90 billion invested.[6]

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

[1] 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.
[2] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980); *see also* S. REP. NO. 96-958 (1980); H.R. REP. NO. 96-1341 (1980). The Act was approved by the U.S. House by a vote of 395-1 and by unanimous consent in the U.S. Senate.
[3] *See* S. REP. NO. 96-958, at 1, 3 (1980).
[4] *See* 15 U.S.C. § 80a-2(a)(46), -54.
[5] *Id.* §80a-2(a)(48)(B).
[6] SBIA BDC Council, 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.[7] Nearly 200,000 U.S. businesses comprise the middle market, which is responsible for one-third of America's private sector gross domestic product.[8] Middle

[7] 3Q 2017 Middle Market Indicator, National Center for the Middle Market.
[8] *Id.*

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

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.[11] 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.[12] 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%.[13] 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.[14] 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.[15] Capitalizing on this small manufacturing renaissance, the number of middle market firms exporting their goods and services has quadrupled over the last six years.[16] 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.[17]

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.[18] 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.[19] 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.[20] 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.[21] 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

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[9] *Id.*
[10] *Id.*
[11] Middle Market Power Index, August 2017, American Express Global Corporate Payments and Dun & Bradstreet.
[12] *Id.*
[13] 3Q 2017 Middle Market Indicator, National Center for the Middle Market.
[14] Middle Market Power Index, August 2017.
[15] *Id.*
[16] *Id.*
[17] SBIA BDC Council, www.bdcsworkforamerica.org.
[18] 3Q 2017 Middle Market Indicator, National Center for the Middle Market.
[19] *Id.*
[20] *Id.*
[21] "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[22] 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.[23] 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.

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[22] 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.

[23] "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.

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.[24] 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.[25]

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.[26] 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.[27]

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.[28] 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

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[24] The BDC Almanac – Episode III, Wells Fargo Equity Research, January 22, 2014.
[25] *Id; see also,* Fitch Wire: "Leverage Limit Increase Could Differentiate BDC Ratings," Fitch Ratings, January 7, 2014.
[26] *Id.*
[27] 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.
[28] *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 (114th)

The current discussion draft of the "Small Business Credit Availability Act" is notably shorter than its predecessor, H.R. 3868, introduced in the 114th 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.[29] 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

[29] 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.