ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

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Ms. Dalia Blass
Director, Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, N.E.
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Submitted via email to rule-comments@sec.gov

10 June 2019

Dear Ms. Blass,

Subject: File Number S7-03-19 – Securities Offering Reform for Closed-End Investment Companies

The Alternative Credit Council[1] (ACC) is a global body that represents asset management firms in the private credit and direct lending space. The ACC has previously expressed our support[2] for the Small Business Credit Availability Act[3] (BDC Act) upon which the Securities and Exchange Commission's (SEC) proposals to modify the registration, communications, and offering processes for BDCs and other closed-end investment companies are based. We therefore broadly welcome the SEC's proposals to enact these reforms.

BDCs play a unique role in the economy by providing debt financing to companies, primarily in small and middle markets, that may find it difficult to obtain traditional bank financing. There are nearly 200,000 U.S. middle market businesses that represent one-third of private sector GDP and employ approximately 47.9 million people.[4] These small and medium-sized businesses are vital to promoting job formation and the growth of the U.S. economy. BDCs benefit borrowers by providing an alternative to the banking sector and promoting competitive markets. Diversifying the sources of funding available to businesses also promotes a strong and resilient economy.

[1] The ACC represents over 170 members that manage more than $400 billion of private credit assets. ACC members provide an important source of funding to the economy by providing finance to mid-market corporates, small and mid-sized enterprises, commercial and residential real estate developments, infrastructure, as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

[2] A copy of our previous submission in support of the Small Business Credit Availability Act is included in the Annex to this letter.

[3] https://www.congress.gov/bill/115th-congress/house-bill/4267/text

[4] Source:https://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2019-Q1/FullReport/NCMM_MMI_Q1_2019_FINAL_web.pdf

The ACC would respectfully suggest three areas where the proposed reforms could be modified to help ensure that the proposals more effectively achieve the policy goals that are driving these reforms. These include:

- Changing the test for determining whether a BDC is a well-known seasoned issuer (WKSI) to include a BDC that (among other factors) has either a public float or a net asset value of $700 million or more;
- Revising the definition of “ineligible issuer” to avoid unintended consequences for BDCs; and
- Not requiring BDCs to report a material write-down in fair value of a significant investment on Form 8-K.

These changes will make the proposals more effective in delivering the policy goals that are driving these reforms. We have provided more detail on the rationale for each of these modifications below.

Net asset value test for determining whether a BDC is a WKSI

The SEC’s proposed reforms would extend all the significant benefits that are available today to corporate issuer WKSIs to BDCs that qualify as WKSIs.[5] We endorse this proposal but would propose an amendment to the WKSI definition to ensure it is appropriate for BDCs.

Under the proposal, a BDC generally must have at least $700 million in “public float” to qualify as a WKSI (in addition to satisfying other conditions).[6] The SEC’s own economic analysis found that only fourteen BDCs, out of a universe of 103 BDCs, would satisfy the public float test and qualify as WKSI.

We urge the Commission to adopt an alternative NAV test for determining whether a BDC is a WKSI. Specifically, we recommend that the Commission define the term “well-known seasoned issuer” to include a BDC that (among other factors) has either a NAV or a public float of $700 million. We believe this change is consistent with the BDC Act and will extend the benefits of WKSI status to a greater number of BDCs than just the fourteen that would benefit under the current proposals.

We believe our recommendation is consistent with the BDC Act. The BDC Act directs the SEC to use the rules available to operating companies, but it does not preclude changes that are necessary to accommodate the differences attributable to BDCs, as compared to corporate issuers. Indeed, the SEC itself recognizes this principle, and proposed changes to the term “ineligible issuer” for BDCs and other closed-end funds that do not apply to corporate issuers. One, which we address in our second recommendation, extends events that disqualify a BDC from WKSI status to an adviser or sub-adviser of the BDC. That proposal strikes us as further afield from the Congressional mandate underlying the BDC Act than our recommendation to customize the WKSI test for BDCs.

[5] As the Commission explains in the proposal, a WKSI can file a registration statement or amendment that becomes effective automatically in a broader of contexts than non-WKSIs. Subject to certain conditions, Commission rules also permit a WKSI to communicate at any time, including through a free writing prospectus, without violating the “gun-jumping” provisions of the Securities Act. In order for an issuer to qualify as a WKSI, the issuer must meet the registrant requirements of Form S-3, i.e., it must be “seasoned,” and generally must have at least $700 million in “public float.”

[6] The proposal explains that Form S-3 defines an issuer’s “public float,” as the “aggregate market value of the voting and non-voting common equity held by non-affiliates.” See General Instruction I.B.1 of Form S-3. The determination of public float is based on a public trading market, such as an exchange or certain over-the-counter markets.

More broadly, we believe the policy intent behind the BDC Act was to enhance the ability of BDCs to tap into the capital markets for the purpose of fulfilling their statutory mandate of making capital available to small and medium-sized businesses. With this backdrop, we believe the SEC should adopt expansive rules, consistent with investor protections, to permit BDCs to more efficiently register offerings and communicate with investors.

Changing the WKSI test for BDCs to add an alternative NAV threshold is appropriate for BDCs and adds only a modest number of BDCs to the list of WKSIs. Unlike an operating company, a BDC determines and regularly makes public a NAV, which is a significant indicator of the likely interest by investors, the financial press, and others, which the SEC said was a consideration for establishing the WKSI standard. For example, a listed BDC that has a NAV of $750 million, but which trades at an 8% discount to NAV would have a public float of less than $700 million. But that discount is not an indicator that investors or the financial press are not interested in the BDC. Nor does it indicate that it is inappropriate, from a policy perspective, to allow BDCs to use the streamlined processes enjoyed by WKSIs for offerings and communications to investors.

In other words, the SEC has determined that size (as measured by public float) is a proxy for investor and analyst interest in a corporate issuer. The same is true for BDCs, but BDCs have two measures of size – public float and NAV. We urge the Commission to use both measures as a proxy for investor and financial press interest in the BDC. If the Commission adopts our recommendation, a greater number of listed BDCs would qualify as WKSIs. This outcome would be consistent with the Congressional intent underlying the BDC Act.

Definition of ineligible issuer

We recommend changes to the SEC's proposal to amend the "anti-fraud prong" of the definition of "ineligible issuer" as it applies to BDCs and other affected funds. An issuer that otherwise qualifies as a WKSI loses that status if the issuer is an ineligible investor. The existing anti-fraud prong of the ineligible issuer definition includes an issuer that, within the past three years, was the subject of a judicial or administrative decree or order arising out of a governmental action involving violations of the anti-fraud provisions of the federal securities laws.

The proposal extends this anti-fraud prong to issuers that are BDCs or other affected funds. The proposal then adds a new element to the anti-fraud prong by providing that a BDC or other affected fund would be an ineligible issuer if "within the past three years any person or entity that at the time was an investment adviser to the issuer, including any sub-adviser" was the subject of any such judicial or administrative decree or order. The SEC explains this proposed change by stating that "investment companies typically are externally managed by an investment adviser, which is primarily responsible for the day-to-day management of the fund and the preparation of the fund's disclosures." The SEC provides no further justification for this change.

We recommend two amendments to the proposed new element of the anti-fraud prong of the ineligible investor definition. First, we urge the SEC to clarify that violations by a BDC's adviser of Section 206(4) of the Investment Advisers Act of 1940 (the Advisers Act), and all the rules adopted under that section except for Rule 206(4)-8, would not result in the BDC becoming an ineligible investor.[7]

The SEC and its staff have referred to Section 206(4) of the Advisers Act as an anti-fraud provision in the past.[8] The rules adopted under Section 206(4), however, are prophylactic in nature. They are designed to prevent – rather than prohibit – an actual antifraud violation. For example, Rule 206(4)-7 of the Advisers Act requires investment advisers to adopt written compliance programs, which typically are extensive and technical. The SEC has brought enforcement action, including in the absence of any fraudulent activity, where an adviser has not fully complied with its compliance program.

It is inherently unfair and harmful to a BDC for it to lose WKSI status because of a technical compliance program violation not involving any fraud. The same could be said for all the rules adopted under Section 206(4), other than Rule 206(4)-8. We do not mean to diminish the importance of these rules, rather to avoid harmful consequences to a BDC whose adviser (or sub-adviser) has a violation of a rule other than a rule prohibiting fraud.

The problem is exacerbated by a lack of any nexus between the adviser's violation and the BDC in the proposed anti-fraud prong. A BDC could lose WKSI status, for example, because its adviser used a client testimonial about the advisers separate account management services. That use would violate Rule 206(4)-1 under the Advisers Act, but is unrelated to the BDC, which would suffer consequences.

Second, we recommend amending the text of the anti-fraud prong to remove the "at the time" element of the definition. The proposal, in effect, provides that the BDC is an ineligible issuer if its adviser or sub-adviser, at the time it was advising the BDC, becomes subject to one of the enumerated decrees or orders. BDCs do not use sub-advisers as commonly as other closed-end funds do. Nonetheless, it would not be fair to a BDC if it loses WKSI status because a sub-adviser was the subject of a SEC enforcement order if that sub-adviser no longer advises the BDC. A better approach may be to apply the test to the time in which the BDC seeks to utilize the benefits of being a WKSI, rather than look at whether the sanctioned adviser was advising the BDC at the time of the sanction.

Reporting material write-downs in fair value of a significant investment on Form 8-K

The proposal would amend Form 8-K to add two new reporting items for BDCs, including new Item 10.02 for material write-downs in fair value of significant investments. An investment would be considered significant if the BDC's and its subsidiaries' investments in a portfolio holding exceed 10% of the total assets of the BDC and its consolidated subsidiaries. The staff requested comment as to whether to allow a BDC to not file a Form 8-K report if the conclusion that a material write-down is required is made in connection with the preparation, review, or audit of financial statements required

[7] We anticipate that the Commission would wish to include as an anti-fraud provision Rule 206(4)-8, which applies antifraud prohibitions in the context of an adviser to a private fund.

[8] *See*, *e.g.*, Statement on Well-Known Seasoned Issuer Waivers, Division of Corporation Finance (July 8, 2011), at footnote 6, available at https://www.sec.gov/divisions/corpfin/guidance/wksi-waivers-interp.htm#P7_148.

to be included in its next periodic report under the Securities Exchange Act of 1934, the periodic report is timely filed, and the conclusion is disclosed in the report.

In general, we applaud the SEC's effort to improve current reporting of information by BDCs to investors and the market, but we believe the requirement to disclose a material write-down in fair value of a significant investment should not be imposed on BDCs. The SEC likens the requirement to an existing requirement in Form 8-K applicable to operating companies to report a material impairment to an asset (such as goodwill, accounts receivable or a long-term asset). Unlike operating companies, the purpose of BDCs is to invest in securities, which inherently change in value. While a material change in a balance sheet asset of an operating company may be an unusual event, a material change in the value of a security is not an unusual event.

The SEC's proposal would only apply to significant assets (that make up at least 10% of the BDC's total assets). Ultimately, investors are affected by a change in the overall NAV per share of a BDC, however. Information about the value of a single asset is not as useful to an investor as stating the NAV per share of a BDC.

As a practical matter, BDCs value their securities when they strike their NAV. Some BDCs only strike NAV monthly or quarterly. These BDCs would not typically assess the value of a significant asset outside of their typical NAV valuation process. Therefore, the BDC would confirm the amount of the material write-down of a significant asset simultaneously with confirming the BDC's overall NAV. Because the overall NAV is the more important measure to an investor and will be available at the same time, the requirement to report a material write-down of an individual asset (even a significant asset) does not meaningfully assist investors.

Summary

The proposals put forward by the SEC would provide BDCs with greater flexibility in the process of offering their securities and communicating with investors and would make capital raising more efficient. This would enable BDCs to spend less time and resources on compliance with outdated and unnecessary securities regulations and invest more of their capital into U.S. businesses. The proposals we have put forward in this letter will enhance the effectiveness of these reforms and support the ability of BDCs to finance growth in the economy.

I would be pleased to discuss the contents of this letter with you or your staff further should you have any questions or require additional information.

Yours sincerely,

Jiří Król
Global Head of the ACC

Annex – ACC comments on S.2324, the "Small Business Credit Availability Act"

March 14, 2018

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

Subject: S. 2324, the "Small Business Credit Availability Act"

On behalf of the Alternative Credit Council ("ACC"),[9] I write to respectfully urge you to support S. 2324, the "Small Business Credit Availability Act," at the appropriate stage in the legislative process. S. 2324 would reform the asset coverage test and offering reform process for Business Development Companies ("BDCs"), and enjoys broad bipartisan support.[10]

The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that manage $350 billion of private credit assets. ACC members provide an important source of funding to the economy by providing finance to mid-market corporates, small and mid-sized enterprises, commercial and residential real estate developments, infrastructure, as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Business Development Companies

There are nearly 200,000 U.S. middle market businesses that represent one-third of private sector GDP and employ approximately 47.9 million people.[11] BDCs play a significant and vital role ensuring that these businesses can access the capital they need to invest, grow, and support new jobs. BDCs benefit borrowers by providing an alternative to the banking sector and promoting competitive markets. Diversifying the sources of funding available to businesses also promotes a strong and resilient economy.

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[9] https://www.aima.org/acc.html.

[10] S. 2324 currently has thirteen bipartisan cosponsors. Additionally, the House Financial Services Committee reported companion legislation (H.R. 4267) favorably to the full House by a bipartisan vote of 58-2 on November 15, 2017.

[11] Source: https://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2017-Q2/FullReport/NCMM_MMI_Q2_2017_FINAL_web.pdf

As vehicles specifically designed to facilitate investment into small and medium size firms, BDCs have played an increasingly important role serving these customers following the retrenchment of traditional lenders from these markets. Although the rationale for BDCs—improving access to capital for these businesses while maintaining robust and responsible lending standards—remains more relevant than ever, some requirements on BDCs are in need of modernization.[12]

S. 2324 would make pragmatic reforms that support the ability of BDCs to provide finance in two key areas.

Reform of the asset coverage test

An unintended consequence of the current asset coverage test is that it restricts the ability of BDCs to raise and invest capital by requiring them to maintain a 1:1 debt to equity ratio. Section 2 of S. 2324 would: (i) raise the asset coverage test from 1:1 to 2:1; (ii) require that BDCs opt-in to this increased ratio via a board or shareholder vote; and (iii) ensure that there is a commensurate increase in investor protection for BDCs that choose to operate with the higher 2:1 debt to equity ratio. This modest increase in the asset coverage test would significantly strengthen the ability of BDCs to lend and support economic growth.

Offering reform

BDCs are currently unable to use the streamlined reporting and registration procedures that are available to similar public companies. This has practical implications for the ability of BDCs to access the capital markets, as offering windows can open and close very quickly, thereby making it harder for BDCs to raise capital. Enabling BDCs to use these streamlined procedures would provide a level playing field, reduce administrative burdens on BDCs, and make it easier for BDCs to raise capital in order to finance American businesses.

S. 2324 would promote economic growth, improve access to finance for U.S. businesses, and has strong bipartisan support in both the Senate and the House. I hope that you will include this important bill in S. 2155 at the appropriate stage in the legislative process to help improve the fortunes of businesses throughout the U.S.

Thank you for considering these views. We would be happy to discuss this legislation further with you and or your staff.

Sincerely,

Jiří Król
Deputy CEO
Global Head of Government Affairs

cc: Members, Senate Banking Committee
Members, House Financial Services Committee
The Honorable Jeb Hensarling, Chairman, House Financial Services Committee
The Honorable Maxine Waters, Ranking Member, House Financial Services Committee

[12] Additional information about the impact of the current BDC requirements on the ability of BDCs to lend are included the appendix to this letter.

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Appendix

Impact of the current BDC requirements and the benefits of the reforms proposed in S. 2324, the "Small Business Credit Availability Act"

<u>Reform of the asset coverage test</u>

The asset coverage test requires BDCs to maintain a minimum 1:1 debt to equity ratio; however, in practice, most BDCs will maintain a lower average leverage ratio. BDCs are required to value their portfolio companies on a "mark to market" basis and any negative changes in the broader loan market may reduce the fair market value of the BDC holdings, regardless of the actual performance of the BDCs' portfolio companies. Any reduction in the fair market value of their holdings leads to an automatic increase in the BDC's debt to equity ratio. BDCs therefore use a lower debt to equity ratio than they are permitted to ensure that there is a buffer in the event of any unexpected or sudden drop in asset values. Although this is prudent behavior from an operational perspective, it restricts the ability of BDCs to invest in U.S. businesses.

An additional consequence of this limitation is to hamstring a BDC's ability to achieve its targeted investment returns by preventing it from using leverage to improve investment returns on lower risk assets. Using leverage to improve returns on lower risk assets is recognized as an effective way of alleviating risk concentration within an investment portfolio. This is generally referred to as a risk parity approach and ensures that any expected risk contribution of the portfolio is spread more evenly across the various individual components that make up a typical diversified portfolio. This can be achieved through disproportionate allocations within the portfolio to lower risk asset classes and a reduction in the exposure to higher risk asset classes. However, for the portfolio to meet its investment return expectation while maintaining a similar degree of risk, some leverage will need to be employed on the investments in the lower risk assets.

The current asset coverage test restricts BDCs from using this approach and makes it more challenging for them to achieve the dividend expectations of their shareholders and RIC distribution requirements. This manifests itself in BDCs being encouraged to invest in higher-yielding and potentially riskier securities, particularly in the non-qualifying assets that are not "eligible portfolio companies" which are permitted to make up to 30% of BDC investments. Non-qualifying assets can be non-U.S. companies, collateralized loan obligations, and a whole range of investments outside of the core small- and medium-sized U.S. businesses.

Increasing the BDC asset coverage test from 1:1 to 2:1 would improve the ability of BDCs to raise capital and invest, without creating undue risk or compromising the responsible lending practices of BDCs. It would also provide BDCs with more headroom to invest in lower yielding (and likely lower risk) assets than they currently enjoy, which will support the construction of diversified portfolios.

This modest increase in the asset coverage test from 1:1 to 2:1 would equalize the BDC leverage ratio with the Small Business Investment Company Debenture program. We also highlight that, under the E.U. Alternative Investment Fund Management Directive, Alternative Investment Funds are only considered to be employing leverage on a substantial basis if their leverage ratio exceeds 2:1—such a ratio is therefore seen as relatively safe and prudent by one of the most stringent asset management regulatory regimes. Furthermore, the proposed increase in the asset coverage test would also require BDCs to operate with significantly less leverage than found in the traditional lending sector.

BDCs use mark to market accounting practices and make regular material disclosures on their activities, which means their activity is extremely transparent compared to other lenders. We also believe that BDCs help to increase the resilience of the financial system, as the activity they undertake does not involve maturity or liquidity transformation—the practice of making long-term loans on money that has been deposited by customers on a short-term basis. Strengthening the ability of BDCs to lend would also encourage diversity in funding sources and competition, thus supporting effective markets.

Offering reform

BDCs are currently unable to use the existing streamlined reporting and registration procedures that are available to similar public companies—specifically, those who also have a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934. In addition to placing BDCs on an uneven playing field, this has practical implications for BDCs that are seeking to access the capital markets, as offering windows open and close very quickly, thereby making it much harder for BDCs to raise capital that they then deploy to small- and medium-sized U.S. businesses.

BDCs should have access to these streamlined reporting and registration procedures. This could be achieved by allowing BDCs to:

- be designated as "well known seasoned issuers" and to make use of an automatic shelf registration;
- access the safe harbors available to other operating companies;
- register on Form S-3 even if they are required to register on Form N-2; and
- rely on the "access equals delivery" rule and use forward incorporation by reference on Form N-2.

These changes would provide BDCs with greater flexibility in the process of offering their securities and communicating with investors and would make capital raising more efficient. This would enable BDCs to spend less time and resources on compliance with outdated and unnecessary securities regulations and invest more of their capital into U.S. businesses.