



BY ELECTRONIC TRANSMISSION

August 5, 2019

Vanessa Countryman, Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: SEC File No. S7-05-19: Ares Capital Corporation Comments on Amendments to Regulation S-X

Dear Madam Secretary:

Ares Capital Corporation (“Ares Capital” or “ARCC”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC”) proposed amendments to rules that require investment companies, and more specifically business development companies (“BDCs”), to include in their SEC filings certain financial information pertaining to their majority-owned and controlled portfolio companies.¹

Ares Capital went public in October 2004 and is the largest BDC in the United States with total assets of \$13.8 billion as of June 30, 2019. Ares Capital has had the opportunity to apply the existing rules referenced in the Proposing Release and to engage in discussions with the SEC Staff (“Staff”) as to how to apply these rules in the past.

We believe that the Proposed Rules described in the Proposing Release follow the spirit of (i) improving the financial disclosure about majority-owned and controlled portfolio companies of BDCs by ensuring that such information is included in the SEC filings of BDCs only when material to investors’ investment decisions and (ii) reducing the time, effort and expense associated with preparing such disclosure for BDCs and their portfolio companies.

Proposed Definition of Significant Subsidiary in Rule 1-02(w)

We are supportive of creating a separate definition of significant subsidiary in Rule 1-02(w) of Regulation S-X specifically for investment companies, including BDCs, and believe that such a step will simplify the application of this rule. With respect to the specific proposal to determine significance, we agree with the approach to have a two-pronged test consisting of an investment test and an income test. The elimination of the asset test is appropriate as it is not meaningful when applied to investment companies and has been a significant source of confusion on the part of BDCs as to how to practically apply the test, particularly given it requires the use of information not included in the investment company’s financial results.

¹ SEC, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, Release No. 33-10635; 34-85765; IC-33465 (May 3, 2019) (the “**Proposing Release**”).

Investment Test

With respect to the revised investment test, we agree that looking at the investment in the tested subsidiary in the context of its relative exposure to total investments at fair value is the appropriate metric in evaluating its significance and therefore, agree with the Staff's approach.

Income Test

We believe the income test as currently proposed requires some clarification to ensure there is consistent application of the test. This clarification may need to come from two perspectives in the context of: 1) Proposed Rule 6-11 for acquisitions ("acquired portfolio") by investment companies and 2) Rules 3-09 and 4-08(g) for disclosure related to existing portfolio companies.

The Proposing Release notes that the revised income test for investment companies specifically uses components from the statement of operations required by Rule 6-07. In particular, the revised income test would include, in the numerator, the following amounts for the most recently completed fiscal year of the tested subsidiary: (1) investment income, such as dividends, interest and other income; (2) the net realized gains and losses; and (3) the net change in unrealized gains and losses. The sum of the absolute value of these income components would be compared to the absolute value of the BDC's change in net assets resulting from operations ("net income").

As noted in the Proposing Release, we agree the income test included in the definition of Significant Subsidiary in Rule 8b-2 is a better proxy for how to approach the revised income test. Under this definition, it states that for investment companies, a subsidiary is considered significant under 8b-2(b) if "the total investment income of the subsidiary exceeds 10% of the total investment income of the parent...", leading us to believe that the best approach is one that uses an "apples" to "apples" comparison between the numerator and the denominator (i.e., comparing investment income from the tested subsidiary to the total investment income of the investment company).

We believe that an income test in line with 8b-2(b) is sufficient and meets the spirit of determining the significance of the tested subsidiary's contribution to the BDC's financial results for the following reasons:

1. *The inclusion of changes in realized and unrealized gains/losses in the income test creates complexities in the calculation due to their variability and, in our opinion, is unnecessary as the impact of such gains/losses is already captured in the investment test.*
 - a. Any net gains or losses from an acquired portfolio or in an existing portfolio company are reflected in the fair value of the investments and thus their significance is already being captured through the investment test as well as the investment test component of the "alternate income test" (e.g., if the investment is substantially appreciated, it would be captured as significant if it's greater than 10% of total investments or if it is substantially depreciated, it will likely not be captured as significant).
2. *The use of a numerator that includes gross income and a denominator that consists of net income seems like an "apples" to "oranges" calculation.*
 - a. Given the proposed calculation, it seems likely that the "alternate income test" will be the primary governor of the outcome of this test versus the 80% threshold of net income

given the “or” nature of the test. Therefore, in line with 8b-2(b), an “apples” to “apples” calculation using 10% of investment income seems to best identify if the acquired company or investment make a significant contribution to the investment income of the BDC.

- i. In the context of an acquisition, this approach would
 1. Consider that the acquiring company’s risk to the acquired company’s investments will be the fair value of the investments at the time of the consummation of the acquisition, and
 2. Eliminate the vagaries of having different expense structures between the acquiring company and the acquired company, as the acquiring company may be capitalized differently, and thus have a different cost of capital, and may also need to incur additional expenses to take on another company. Rather than having to determine what the combined net income might look like, an investment income-based approach would be more straight forward while capturing the spirit of determining significance.
- ii. In the context of an existing portfolio company, this approach would
 1. Consider that the fair value of the investment already captures any gains and losses, and
 2. Relieves the BDC from having to consider what expenses should be attributed to the investment income generated by holding that investment, which should arguably be removed from the numerator to achieve an “apples” to “apples” comparison of the net income impact from that investment.

Regardless of the approach to the income test, for existing portfolio companies, it would be helpful to confirm that the numerator for the income test will use the income elements that are actually reported by the BDC (i.e., the numerator uses the investment income earned from the BDC’s investment in the portfolio company being tested). We believe that utilizing the income components as directly reflected in the BDC’s financial results for both the numerator and denominator is the most appropriate and straightforward approach and will allow for consistent application of the income test. We also believe this would reflect the true economic exposure of the BDC to a particular investment, much in the same way that the investment test does.

To the extent that the components of the income test remain as proposed, we believe there should be further clarifications regarding the computations required to perform the test. First, it is unclear whether the income test should be calculated by (1) combining the separate absolute values of each of the three income components listed or (2) combining each of the income components first, and then using the absolute value of the combined amount. If it is determined that gains and losses should remain in the income test, then we believe that the best methodology would be to utilize the sum of (i) investment income plus (ii) the absolute value of total net realized and unrealized gains/losses. This would at least help to minimize any significant movements within the net gains and losses and only include in the tests the net impact of such gains and losses. In addition, we believe that the investment test threshold of 5%

in the “alternate income test” is unnecessarily low and should be 10% in line with the investment test and 8b-2(b).

Second, under the Proposing Release, a five-year average would be used for the income test for investment companies if the BDC and its consolidated subsidiaries has an insignificant change in net assets resulting from operations. If the income test remains as proposed, we believe that the utilization of a five-year average should be applied in all situations, and to both the numerator and denominator, to also help avoid any significant one-time fluctuations in the consideration of a tested subsidiary as significant. For example, the five-year average should be applied to both the numerator and denominator of the income test, or the sum of the absolute value of (i) investment income and (ii) net realized and unrealized gains/losses of the tested subsidiary and the BDC, respectively, utilizing figures as reported by the BDC on its statement of operations. Further guidance should be provided for the determination of “insignificance” as it relates to the Staff’s proposal for the utilization of the five-year average.

Rules 3-09, 4-08(g) and 10-01(b)(1) of Regulation S-X for Investment Companies

The change in the definition of Significant Subsidiary under Rule 1-02(w) for investment companies in the Proposing Release would impact a BDC’s application of Rule 3-09 regarding separate financial statements for significant subsidiaries and Rule 4-08(g) regarding summarized financial information of subsidiaries not consolidated for existing portfolio companies. We believe that there should be further amendments to Rule 3-09 to incorporate changes to the proposed amendments to the investment test and the income test, including the proposed alternate income test. Consistent with the current application of Rule 3-09 of substituting 20% for 10%, we believe that Rule 3-09 should be further amended as it relates to the proposed investment and income tests to substitute 20% for 10%, and in the case of the investment test component of the “alternate income test” that 20% should be used for this purpose.

We also believe that Rule 3-09 should be further amended to eliminate the audited financial statement requirement given that unaudited financial statements would serve the same purpose of informing investors about the financial condition and results of operations of significant majority-owned portfolio company investments, while avoiding the extraneous time, effort and expense spent by BDCs and their portfolio companies in obtaining audited financial statements. As such extraneous costs are ultimately borne by the BDC, we believe it is in the best interests of shareholders to limit such costs.

Finally, we believe that Rules 3-09, 4-08(g) and 10-01(b)(1) should not apply to portfolio company investments that are no longer held by the BDC at the applicable filing date as the final outcome of the investment is known, and such investments are no longer of any relevance to investors in the BDC. This is supported by the fact that the BDC may not be able to obtain the information needed to prepare the additional financial disclosures for the portfolio company for inclusion in the BDC’s SEC filings when it no longer owns/controls the portfolio company.

Rule 6-11 of Regulation S-X

We believe that Rule 6-11 should be revised to eliminate additional reporting requirements for acquired companies that have reported financial statements in accordance with Regulation S-X prior to the consummation of the acquisition by the acquiring company as the acquired company’s financial information is already publicly available. As proposed, Rule 6-11 appears to place an undue burden and cost on an acquiring company to produce audited financial statements when the acquired company ceases to exist and thus no longer has a requirement to report financial statements in accordance with Regulation S-X. Additionally, the acquiring company will present its financial results, including the acquired

company's assets and liabilities, in its next periodic filing so there will be minimal time between closing on the acquisition and publicly presenting the results of the acquisition.

In addition, the production of audited financial statements for acquired companies that have not reported financial statements in accordance with Regulation S-X also pose an undue burden given that unaudited financial statements would serve the same purpose while avoiding the extraneous time, effort and expense in producing audited financial statements.

We appreciate the opportunity to respond to the request for comments on the Proposing Release and welcome the opportunity to meet with the SEC Staff and discuss these issues further. If you have any questions regarding our comments, or if we can provide additional assistance, please do not hesitate to contact Penni Roll ([REDACTED] or [REDACTED]) or Scott Lem ([REDACTED] or [REDACTED]).

Sincerely,

Penni F. Roll
Chief Financial Officer

Cc: The Honorable Jay Clayton, Chairman
The Honorable Robert J. Jackson Jr., Commissioner
The Honorable Allison H. Lee, Commissioner
The Honorable Hester M. Peirce, Commissioner
The Honorable Elad L. Roisman, Commissioner
Ms. Dalia O. Blass, Director, Division of Investment Management