BY ELECTRONIC TRANSMISSION

December 4, 2020

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

Re: SEC File No. S7-09-20; Release Nos. 33-10814; 34-89478; IC-33963: SBIA Comments on Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements

Dear Ms. Countryman:

The Small Business Investor Alliance ("***SBIA***") appreciates the opportunity to comment on the Securities and Exchange Commission's ("***SEC***") proposed amendments to rules that require an open-end management investment company to disclose "acquired fund fees and expenses" (***"AFFE"***), *i.e*., its *pro rata* share of the operating expenses charged by underlying funds in which the fund invests, as an additional line item in its prospectus fee table (such disclosure requirement is referred to herein as the "***AFFE Rule***").[1]

The SBIA is a national association that develops, supports, and advocates on behalf of policies that benefit investment funds that finance small and mid-size domestic businesses in the middle market and lower middle market, as well as the investors that provide capital to these funds.

Our membership includes funds electing business development company ("***BDC***") status under the Investment Company Act of 1940 (the "***1940 Act***") and their external managers, as well as the investors that invest in these funds, including, but not limited to, banks, family offices and funds of funds.

At the outset, we applaud the SEC for taking into account many of the comments submitted by the BDC industry[2] in response to the SEC's "Funds of Funds Arrangements" rule proposal[3] in formulating the proposed amendments to the AFFE Rule. In particular, the Proposing Release acknowledges comment letters that express concern about the unique harm suffered by BDCs when providers of broad-market indices, such as the S&P 500 Index and the Russell 2000 Index, exclude BDCs from their indices solely

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[1] SEC, *Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements,* IC Release No. 33963 (August 5, 2020) (the "***Proposing Release***").

[2] *See* Comment letter submitted by the SBIA dated April 30, 2019, *available at* https://www.sec.gov/comments/s7-27-18/s72718-5431570-184653.pdf.

[3] SEC, *Funds of Funds Arrangements*, IC Release No. 33329, 84 Fed. Reg. 1286 (Feb. 1, 2019), available at https://www.sec.gov/rules/proposed/2018/33-10590.pdf.

because of the disproportionate impact of the AFFE Rule on the total annual fund operating expense ratio (***"expense ratio"***) disclosed in the prospectus fee tables of mutual funds and exchange traded funds (***"ETFs"***) that track these indices (***"index funds"***).

The Proposing Release asks, among other things, whether the proposed amendments address the concerns regarding the AFFE Rule's impact on BDC investments.[4] In this regard, the proposed amendments would allow a fund that invests 10% or less of its total assets in underlying funds (***"Acquired Funds"***) to disclose AFFE in a footnote rather than as a separate line item in the fee table.[5] On the other hand, a fund that invests more than 10% of its total assets in Acquired Funds still would be required to include the AFFE line item in its fee table and increase its expense ratio by that amount. Although the proposed amendments are a significant positive step, they fall short in one respect that is critical to BDCs. The 10% limit may not be sufficient to assure index funds that there is no risk that they will be required to include the AFFE line item in their fee tables if they track indices that include BDCs. Without this assurance, it is unclear whether the index providers will again include BDCs in their indices.

The most severe unintended consequence of the AFFE Rule has been the removal and continued exclusion of BDCs from the indices. Therefore, in response to the request for comments in the Proposing Release, we make the following recommendations:

- The SEC should move the AFFE line item out of the fee table to a footnote or to a narrative discussion accompanying the fee table and should amend the AFFE disclosure requirements in Form N-2 for BDCs in the same manner.

- In the alternative, the SEC should exempt BDCs from the definition of Acquired Fund under Forms N-1A, N-2, N-3, N-4 and N-6 (the ***"Forms"***).

We believe that our recommended changes to the proposed amendments to the AFFE Rule advance the SEC's objectives of providing investors with (a) "a better understanding of the actual costs of investing in a fund that invests in other funds" and (b) "the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund"[6], while addressing the unique harm suffered by BDCs when providers of broad-market indices, such as the S&P 500 Index and the Russell 2000 Index, exclude BDCs from their indices solely because of the disproportionate impact of the AFFE Rule on the expense ratio disclosed in the prospectus fee tables of funds that track these indices.

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[4] Proposing Release at 305.

[5] Instruction 3(f)(i) to Item 3 in Form N-1A defines "Acquired Fund" as "any company in which the Fund invests or has invested during the relevant fiscal period that (A) is an investment company or (B) would be an investment company under section 3(a) of the [1940 Act] but for the exceptions to that definition provided for in sections 3(c)(1) and 3(c)(7) of the [1940 Act]." The identical definition appears as proposed Instruction 4(f)(i) to proposed Item 8A in Form N-1A.

[6] SEC, *Fund of Funds Investments*, IC Rel. No. 27399, 71 Fed. Reg. 36640 (June 20, 2006), available at https://www.sec.gov/rules/final/2006/33-8713.pdf.

Background on BDCs

Congress created BDCs in 1980 pursuant to the Small Business Investment Incentive Act ("***SBIIA***")[7] as a specialized type of closed-end investment company whose principal activities consist of investing in, and providing managerial assistance to, small, growing, or financially troubled U.S. businesses. To this end, the SBIIA generally requires a BDC to invest at least 70% of its portfolio assets in cash (or high quality, short-term debt securities), securities issued by financially troubled businesses, or certain securities issued by "eligible portfolio companies," which generally include U.S. companies that: do not have a security listed on a national securities exchange (*i.e*., are private companies) or have a security listed on a national securities exchange but have less than $250 million of common shares outstanding; are not investment companies; and would not be investment companies but for an exclusion from the definition of "investment company" in section 3(c) of the 1940 Act.[8] The remaining 30% of a BDC's portfolio assets are not limited by these investment restrictions and can be invested freely. 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 those eligible portfolio companies that comprise at least 70% of the value of the BDC's total assets.[9]

After the passage of the SBIIA, changes in banking regulation – including the repeal of the Glass-Steagall Act of 1933 (which led to a wave of bank consolidations), heightened capital and liquidity requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the U.S. implementation of the international Basel III Accord (which limits banks' ability to hold unrated debt) – caused banks to significantly curtail lending, particularly to smaller and less-established companies that lack credit ratings or are otherwise subject to greater credit risk. BDCs have helped to fill this void and have emerged as a vital source of financing for small- and mid-sized U.S. businesses. In recognition of this fact, Congress passed the Small Business Credit Availability Act of 2018, which facilitated the ability of BDCs to raise capital by engaging in additional borrowing and accessing certain streamlined securities registration rules. While BDCs account for a small percentage of the assets managed by all regulated investment companies, assets managed by BDCs have grown rapidly over the past two decades from net assets of just $5 billion at the end of 2003. As of March 2020, the BDC industry was comprised of over 85 BDCs with over $135 billion in aggregate assets.[10]

BDCs provide a number of important benefits to investors, including the following:

- BDCs generally offer a meaningful and consistent source of income to their investors despite the current low interest rate environment. This feature is particularly important to income-seeking investors.

- BDCs allow smaller investors, including retail investors, to access private and middle market company credit, a differentiated asset class otherwise available only to wealthy individuals and

[7] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

[8] 8 *See* Section 2(a)(46) of the 1940 Act.

[9] *See* Section 2(a)(48) of the 1940 Act (requiring a BDC to make available significant managerial assistance with respect to the companies that the BDC treats as satisfying the 70% of the value of its total assets condition of section 55).

[10] Proposing Release at 352.

large institutions (*e.g*., through investments in private equity funds, hedge funds, or direct investments).

- Exchange-traded BDCs provide liquidity to private credit, an illiquid asset class.

- BDCs are subject to substantial regulatory requirements, including restrictions on transactions with affiliates, fair valuation requirements, auditing and disclosure requirements, and governance requirements that enhance transparency and mitigate risk of loss and shareholder dilution.[11]

Background on the AFFE Rule and its impact on BDCs

In 2006, the SEC adopted amendments to the Forms for registration statements used by registered investment companies and BDCs to offer their securities that require a registered fund or BDC to disclose as an additional line item in its prospectus fee table its *pro rata* share of the total annual operating expenses paid by funds in which the acquiring fund invests.[12] This line item expense is added to the acquiring fund's *actual* operating expenses and increases the acquiring fund's total annual operating expenses, *i.e.* the "bottom line" expense ratio shown in the prospectus fee table.

BDCs are unique among regulated funds in that they engage in the labor-intensive and costly process of evaluating prospective small and medium-sized nonpublic companies, negotiating the terms of the portfolio securities in which they invest, monitoring portfolio company performance, and making available "significant managerial assistance." Because of the nature of the BDC business model, a BDC's expense ratio can be higher than the expense ratio of a typical mutual fund, closed-end fund, or ETC. In addition, most BDCs use leverage, and incur interest charges on such leverage. It follows that the BDCs in an index disproportionately elevate the AFFE line item in the prospectus fee table of an index fund tracking that index, which, in turn, increases the index fund's expense ratio.

The expense ratio is a critical factor in distinguishing competing index funds.[13] Among index funds, low operating expenses, rather than a talent for selecting investments, is likely to distinguish a desirable index fund from a less desirable index fund. A high expense ratio can eliminate an index fund from further consideration, irrespective of the historical return profile. To minimize the effect of AFFE on the expense ratio as disclosed in the prospectus fee tables of index funds, the mutual fund industry pressured index providers to remove eligibility of BDCs from their indices. In March 2014, for example, Russell announced that BDCs would no longer be eligible for inclusion in its family of indices. Russell cited the

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[11] BDCs and their investment advisers, are subject to regulation under the 1940 Act, Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the rules promulgated under each. Additionally, non-traded BDCs are further subject to regulation by up to 54 state and territorial securities regulators, and the distribution of non-traded BDC securities is subject to regulation by the Financial Industry Regulatory Authority.

[12] SEC, *Fund of Funds Investments*, IC Release No. 27399, 71 Fed. Reg. 36640 (June 20, 2006), available at https://www.sec.gov/rules/final/2006/33-8713.pdf.

[13] *See, e.g.,* ignites, *Vanguard Swaps Indexes in Cost-Cutting Move* (October 2, 2012) (Jackie Noblett), available at https://www.ignites.com/c/417481/46971?&referrer_module=article.

"distortive impact" of the AFFE requirements as the reason for this decision.[14] S&P and others followed later in 2014.

Over the past decade, BDCs have grown significantly, as they seek to fulfill their stated mission of providing capital to U.S. middle-market companies. However, if BDCs were no longer subject to the harmful effects of AFFE such that they could once again be eligible for inclusion in the indices, BDCs could raise capital from a greater variety of funds, which would stimulate even more growth in the BDC industry.[15] The immediate, direct effect of BDCs' exclusion from the indices was that index funds were effectively barred from investing in BDCs at a time when index mutual funds and ETFs were accounting for an increasing proportion of the investment market. Former Commissioner Robert J. Jackson Jr. states that "[t]he decision to include a company in the S&P 500, for example, results in a reallocation of billions of dollars of investors' money" and that "[t]he average company added to the S&P 500 gains value; when it's removed, its share price drops as index funds sell their holdings."[16] Enabling BDCs to regain access to capital investment by institutional investors through inclusion in the indices will render them better equipped to offer funding and expertise in loan tailoring to more U.S. middle-market companies, thereby carrying out the intent of the SBIAA

The substantial decline in capital investment by index funds in BDCs harms investors in those funds on the one hand, and investors in BDCs on the other hand. The AFFE Rule resulted in an overstatement of actual expenses incurred by BDC investors, which led to the removal of BDCs from the indices and a dramatic reduction in BDCs' institutional ownership. On the one hand, because BDCs are no longer included in the indices, index funds are prohibited from investing in BDCs and, consequently, their investors are deprived of the potential returns that BDCs can provide.[17] On the other hand, BDCs, due to their exclusion from the indices, are restricted from index fund investment, which is a valuable source of capital raising. As a result, BDCs are not able to access capital through index fund investment, which serves to limit BDC investment activities and hinders optimal BDC performance, thereby hurting investors in such BDCs. Liquidity of BDC shares has declined substantially since BDCs were dropped from the major indices.[18] The reduction of BDC investment by mutual funds and ETFs has also reduced

[14] Barron's, *Russell Sets Terms for Booting BDCs: Should You Buy the Dip?* (Mar. 4, 2014) (Brendan Conway), available at https://www.barrons.com/articles/russell-sets-terms-for-booting-bdcs-should-you-buy-the-dip1393960960. By eliminating BDCs from the Russell 2000 Index, Russell index funds with disclosed expense ratios of from 20 to 30 basis points could reduce the expense ratio disclosed in their prospectus fee tables by 5 to 7 basis points. Wells Fargo Securities Equity Research, *The 2Q18 BDC Scorecard* (Jan. 18, 2017) ("***2Q18 BDC Scorecard***"). The disclosed expense ratio reduction, of course, would have no effect on fund performance.

[15] Davydiuk, Marchuk and Rosen, *Direct Lending in the U.S. Middle Market*, (June 30, 2020) available at https://ssrn.com/abstract=3568718.

[16] The New York Times, *What's Really in Your Index Fund?* (Feb. 18, 2019) (Robert J. Jackson Jr. and Steven Davidoff Solomon), available at https://www nytimes.com/2019/02/18/opinion/index-fund.html?searchResultPosition=1.

[17] This applies to actively managed funds, as well. A fund adviser that lacks the resources necessary to invest directly in small and middle market companies can gain exposure to these markets by investing in BDCs. Moreover, unlike direct small and middle market investments, BDC shares are highly liquid. Thus, a fund manager can increase or decrease the fund's exposure to these markets in an instant.

[18] Bock, O'Shea and Mazzoli, *New SEC Leadership Announced and Hopefully A Fresh Take on an Old Rule*, Equity Research (Wells Fargo Securities, LLC) (Sept. 7, 2017), Exhibit 11 -- Russell Commentary on BDC Exclusion.

institutional ownership of BDC shares, thereby depriving BDCs of institutional investors' leadership efforts in corporate governance best practices.[19]

In connection with the review of the AFFE Rule, a highly-regarded (former) research analyst in the BDC industry observes that "[l]arge institutional investors are often much better [than retail investors] about actively vetting corporate/board proposals."[20] In this regard, institutional shareholders are significantly more likely to participate in shareholder meetings than retail shareholders, particularly fund managers, which are subject to a fiduciary obligation to do so. Increased involvement and communication from institutional investors in BDC corporate governance is ultimately beneficial for retail shareholders and will enhance the long-term performance of BDCs.

Recommendations

Move the AFFE disclosure outside the fee table to a footnote or accompanying narrative

In her statement on the Proposing Release, Commissioner Hester M. Peirce first observes that funds that limit their investments in other funds to 10% or less of their total assets would be able to include the AFFE data in a footnote to the fee table, rather than in the fee table itself, and then asks, "Would it make more sense for all AFFE disclosure to be in the footnotes?"[21] In our view, it would.

AFFE footnote or narrative disclosure more likely to enable BDCs to return to indices

For the BDC industry, it is critical that any reform of AFFE disclosure assure index funds that they will not risk being required to include the AFFE disclosure in their fee tables if they track broad based indices that include BDCs. Absent this assurance, the index providers may be unwilling to again include BDCs in their indices. In this respect, the proposed amendments fall short. Many index funds do not purchase every security represented in an index. Rather, to minimize transaction costs, they strive to replicate the index's performance by purchasing a representative sample. If that sample includes BDCs from the index but excludes companies that are not Acquired Funds from the index, then the Acquired Funds percentage in the sample may be higher than the Acquired Funds percentage in the entire index. Thus, although BDCs and other Acquired Funds might comprise only 5% of the aggregate value of an index, Acquired Funds could represent a much higher percentage of an index fund's sample. Over time and in volatile markets, at least in theory, the index fund's Acquired Fund holdings could approach 10% of the index fund's assets. The index fund would be faced with the dilemma of either modifying its sampling program or crossing the 10% threshold and thereby inflating its expense ratio. Permitting an index fund, regardless of the magnitude of its Acquired Fund investments, to move the AFFE disclosure outside the fee table to a footnote or accompanying narrative would eliminate this risk.

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[19] 2Q18 BDC Scorecard. *See also* Raymond James, BDC Ownership Percentage by Investor Type (April 2019). The market cap weighted average of BDC ownership by institutional investors plunged by approximately one-quarter year-over-year between the end of Q413 (42.2%) and Q414 (31.7%). This percentage decline increased to approximately 35 percent through Q418 (27.6%). (*unpublished report with data sourced from FactSet; institutional holdings for December 31, 2018, and December 31, 2015, excluding holdings from private banks/wealth management firms, brokers and investment banks; and insider holdings.*)

[20] Wells Fargo Q117 BDC Scorecard

[21] Public Statement, Commissioner Hester M. Peirce, Statement on Tailored Shareholder Reports (Aug. 5, 2020), available at https://www.sec.gov/news/public-statement/peirce-statement-tailored-shareholder-reports-080520.

AFFE footnote or narrative disclosure will better serve the goal of providing investors with an improved understanding of the actual costs of investing in a fund that invests in other funds

More broadly, moving all AFFE disclosure out of the fee table would better serve the SEC's stated goals than the proposed amendments. The adopting release for the AFFE Rule states that by showing investors the indirect expenses associated with underlying fund investments, the AFFE requirements are designed to provide investors with (a) "a better understanding of the actual costs of investing in a fund that invests in other funds" and (b) "the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund."[22]

The existing AFFE Rule undermines the SEC's stated goal of providing "a better understanding of the *actual* costs of investing in a fund that invests in other funds (emphasis added)." As noted in the Proposing Release, the AFFE line item component of a fund's expense ratio is not a true fund operating expense. That line item is *not* deducted from the acquiring fund's net investment income and therefore does not reduce the fund's total return or net asset value. The AFFE line item is added to expenses that actually *are* deducted from the fund's net investment income. The sum is labelled "Total Annual Fund Operating Expenses," which amounts to a legally mandated misrepresentation.[23] It is as if the AFFE line is an apple, the true operating expenses are an orange, and the fee table adds them together and shows the sum as two oranges. The "Expense Example" that follows the fee table reinforces this misimpression by using the inflated expense ratio to calculate the operating expenses for various time periods of a $10,000 investment in the acquiring fund.

The AFFE Rule recognizes that the expense ratio in the fee table is inconsistent with the expense ratio disclosed in the acquiring fund's financial highlights and permits the fund to state as much in a footnote.[24] In addition to using the footnote, some fund prospectuses attempt to correct the misimpression that the AFFE line in the fee table is an additional expense borne by fund investors. As an example, the prospectus for the Hartford fund complex discloses:

> The Fund will indirectly bear a *pro rata* share of fees and expenses incurred by any investment companies in which the Fund is invested … BDC expenses are similar to the expenses paid by any operating company held by the Fund. They are not direct costs paid by Fund shareholders and are not used to calculate the Fund's net asset value. They have no impact on the costs associated with Fund operations.[25]

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[22] SEC, *Fund of Funds Investments*, IC Release No. 27399, 71 Fed. Reg. 36640 (June 20, 2006), available at https://www.sec.gov/rules/final/2006/33-8713.pdf.

[23] Proposed Item 8A in Form N-1A replaces "Total Annual Fund Operating Expenses" with "Total Ongoing Annual Fees," which suggests some awareness that that an expense ratio that includes AFFE does not accurately reflect a fund's operating expenses. The proposed new label, however, does not cure the misimpression.

[24] Instruction 3(f)(v) to Item 3 of Form N-1A. Similarly, proposed Instruction 4(f)(viii) to proposed Item 8A of Form N-1A would permit a fund to explain that the expense ratio in the fee table does not "correlate to the ratio of expenses to average net assets given in the fund's shareholder reports."

[25] Hartford Series Fund, Inc., Form 484B, filed June 23, 2020, available at https://www.sec.gov/Archives/edgar/data/1053425/000110465920076127/tm2022842d1_485bpos htm.

Not surprisingly, fund complexes have concluded that the prospectus narrative is not sufficient to overcome the misimpression created by the numbers in the fee table and the Expense Example.

All funds should include AFFE disclosure outside of the fee table to facilitate the comparison of fund costs

The proposed amendments may undermine the second objective of the AFFE Rule, facilitating the comparison of fund costs. Some funds will have an expense ratio unaffected by the AFFE line item because it is outside of the fee table. Others will have the AFFE line item in the fee table as a component of the expense ratio. In theory at least, some funds with investments in Acquired Funds below the 10% limit may elect to include AFFE disclosure in the fee table while others will not. Because the 10% limit is based on an acquiring fund's total assets, a fund that has a higher AFFE percentage than a fund with otherwise identical expenses might avoid fee table disclosure while the other fund cannot. For example, a fund investing 10% of its total assets in underlying funds with very high expense ratios need not include the AFFE line item in its fee table, but a fund investing 11% of its total assets in funds with very low expense ratios must. The first fund's AFFE percentage will be higher than the second fund, but the former is not required to include the AFFE line item in its fee table and consequently will have a lower expense ratio. This is not a disclosure regime that facilitates comparisons. Requiring all AFFE disclosure in the same place, *i.e.*, outside of the fee table, would make footnotes explaining why the expense ratio in the fee table differs from the financial statements unnecessary and facilitate comparison of funds, thereby reducing investor confusion.

Where Acquired Funds comprise 10% or less of the acquiring fund's total assets, the proposed amendments correct the misimpression caused by the AFFE Rule. The optional footnote stating that the expense numbers in the fee table do not match the numbers in the fund's shareholder report and additional prospectus disclosure explaining that the AFFE line in the fee table is not an actual fund expense would be unnecessary. Permitting all funds, regardless of the magnitude of their Acquired Fund investments, to disclose AFFE outside of the fee table would extend these benefits to all funds and at the same time facilitate the comparison of fund fees. The common-sense answer to Commissioner Peirce's question is yes, it would make sense to move all AFFE disclosure out of the fee table.

Consistent amendments should be made to the AFFE disclosure requirements in Form N-2 for BDCs

In the Proposing Release, the SEC requests comment on whether the AFFE disclosure requirements should be amended in registration statements for other types of investment companies, including Form N-2.[26] The AFFE disclosure requirements in Form N-2 should be amended in order for BDCs to be on equal footing with open-end investment companies with respect to AFFE. With the recent adoption of new rule 12d1-4 under the 1940 Act ("***Rule 12d1-4***"), BDCs will be permitted to acquire shares of another regulated fund in excess of the limits currently imposed by Section 12(d)(1)(A).[27] Rule 12d1-4 provides flexibility for BDCs to utilize fund of funds arrangements without the need to seek individualized exemptive relief, so long as the arrangements satisfy the conditions of Rule 12d1-4. Rule 12d1-4 serves

[26] Proposing Release at 305.

[27] Final Rule on Fund of Fund Arrangements, Rel. No. 33-10871 (Oct. 7, 2020).

to open more investment channels for BDCs, as well as make it easier for funds to incrementally invest in such regulated funds. In approving Rule 12d1-4, the SEC has afforded greater investment flexibility for BDCs. We believe that BDCs should similarly benefit from the amended AFFE disclosure requirements, which will take on greater importance as fund of funds arrangements are pursued. The recommendations set forth below are intended to apply not only to the AFFE disclosure requirements as included in Form N-1A, but also with respect to Form N-2.

In the alternative, the SEC should exempt BDCs from the definition of "Acquired Fund" under the Forms

The Proposing Release asks, in essence, whether BDCs should be excluded from the definition of Acquired Fund in the Forms and, if so, how BDCs can be distinguished from other pooled investment vehicles that are included.[28] We strongly believe that the SEC should exclude BDCs from the definition of Acquired Fund in the Forms and that BDCs differ in meaningful ways from other investment vehicles included in the definition.

BDCs serve a unique purpose

The SEC staff has recognized that the definition of Acquired Fund encompasses certain investment vehicles the AFFE Rule was not intended to include. In 2007, the SEC staff issued guidance (in the form of answers to a series of frequently asked questions) that excluded from the definition of Acquired Fund "structured finance vehicles, collateralized debt obligations, or other entities *not traditionally considered pooled investment vehicles* (emphasis added)."[29] We believe that a BDC should also be regarded as a non-traditional pooled investment vehicles because of the high degree of active management required to assemble and manage a portfolio of BDC investments.

As discussed above, the SBIIA created BDCs in 1980 to address the slowing of capital flow to small and middle-market companies, with such companies having proven important to innovation, productivity, and job creation in the U.S. economy. BDCs originate loans to these middle-market companies on a day-to-day basis and they have the resources necessary to provide valued intellectual, as well as financial, capital to middle market borrowers. In order to support BDCs in their stated objective of lending to middle market companies, the SBIIA amended the 1940 Act to provide BDCs with significantly more operating flexibility than other investment companies regulated under the 1940 Act.[30] BDCs actively negotiate investment terms with the portfolio companies at the time of the initial investment and not infrequently during the holding period. Sourcing, underwriting, negotiating and managing directly originated loans, for example, is a specialized process that strongly resembles the commercial lending operations of a bank.

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[28] Proposing Release at 305. The definition of "Acquired Fund" appears in proposed Instruction 4(f)(i) to proposed Item 8A in Form N-1A. The proposed definition is unchanged from the current definition. *See* footnote 5, *supra*.

[29] SEC Division of Investment Management, *Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses* (May23, 2007), available at https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm.

[30] For example, Section 17(a) and Section 17(d) and Rule 17d-1generally prohibit any affiliated person of a registered fund, or affiliated persons of the affiliated person, from engaging in certain transactions with that registered fund, including on a principal or joint basis. The 1940 Act's BDC provisions generally track Section 17 but treat transactions with close affiliated persons differently from transactions with more remote affiliated persons. *Cf.* Sections 57(a), (b) and (c) to Sections 57(d), (e) and (f). In addition, Section 57 of the 1940 Act and Rule 57b-1 thereunder allow a BDC to engage in transactions with controlled portfolio companies that the 1940 Act otherwise prohibits.

Moreover, Congress imposed on BDCs a statutory duty to offer to make available significant managerial assistance to their portfolio companies.[31] As a result, many BDCs provide portfolio companies with critical managerial expertise. Many BDCs provide portfolio companies with managerial and strategic financial expertise, often by partnering with private equity sponsors to optimize a portfolio company's entire capital structure. BDCs and their advisers often participate in corporate governance, provide input on strategic transactions and other key corporate decisions, and participate in the negotiation of sales and restructuring agreements. BDCs have higher operating expenses than traditional mutual funds and ETFs, in part, due to this very engagement in the negotiation of investment terms and in the affairs of their portfolio companies. In recognition of this "hybrid structure," the 1940 Act allows a BDC significantly more operating flexibility than other investment companies regulated under the 1940 Act.[32] Unlike traditional mutual funds, BDCs are also required to file annual, quarterly, and current reports under the Securities Exchange Act of 1934.

We note that other investment vehicles similar to BDCs fall outside of the definition of Acquired Fund and therefore are not subject to the AFFE Rule. A mortgage real estate investment trust ("***REIT***"), for example, is similar to a BDC. REITs often participate in the management or operation of a portfolio of real estate properties and mortgages. BDCs and REITs both distribute income to investors on a pass-through basis, share similar expense structures and are often distributed through similar distribution channels. REITs, however, remain constituents of many of the major market indices. Excluding BDCs from the definition of Acquired Fund, therefore, would simply put them on equal footing with similar pooled investment vehicles such as collateralized debt obligations and REITs.

Excluding BDCs from the definition of Acquired Fund should result in growth in the size and number of BDCs and also translate into improved access to financing and better terms for borrowers. Congress has recognized that, by limiting inflows into BDCs, the AFFE requirements have had the adverse effect of stifling capital formation in the U.S. middle markets. In its report on the 2019 Financial Services and General Government Appropriations bill, the House Committee on Appropriations has called on the SEC to take action to mitigate the "unintended, harmful consequences" imposed on BDCs by the AFFE disclosure requirements.[33] In addition, during a recent hearing of the Senate Banking, Housing, and Urban Affairs Committee entitled "Legislative Proposals on Capital Formation and Corporate Governance," Committee member and Pennsylvania Senator Pat Toomey observed that "BDCs have become a really important source of capital for small and growing companies" and that the "application of the SEC's [AFFE requirements] has a particularly adverse impact on BDCs . . . ."[34] He also called the

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[31] *See* Section 2(a)(48) of the 1940 Act (requiring a BDC to make available significant managerial assistance with respect to the companies that the BDC treats as satisfying the 70% of the value of its total assets condition of section 55).

[32] For example, Section 17(a) and Section 17(d) and Rule 17d-1generally prohibit any affiliated person of a registered fund, or affiliated persons of the affiliated person, from engaging in certain transactions with that registered fund, including on a principal or joint basis. The 1940 Act's BDC provisions generally track Section 17 but treat transactions with close affiliated persons differently from transactions with more remote affiliated persons. *Cf.* Sections 57(a), (b) and (c) to Sections 57(d), (e) and (f). In addition, Section 57 of the 1940 Act and Rule 57b-1 thereunder allow a BDC to engage in transactions with controlled portfolio companies that the 1940 Act otherwise prohibits.

[33] H.R. Rep. No. 115-792, 115th Cong., 2d Sess. (2018).

[34] *Legislative Proposals on Capital Formation and Corporate Governance*, Open Hearing before the S. Comm. on Banking, Housing, and Urban Affairs, 116th Cong., 1st Sess. (2019) (statement of Sen. Patrick J. Toomey, Member, S. Comm. on Banking, Housing, and Urban Affairs).

AFFE requirements "inappropriate," noting that a BDC's market price already reflects its fees.[35] At the same hearing, a representative from the U.S. Chamber of Commerce indicated that the Chamber shares Senator Toomey's concerns and agrees that BDCs should be excluded from the AFFE disclosure requirements given their critical role in meeting the funding needs of many new and existing U.S. businesses, particularly since the 2008 financial crisis. More recently, Representative Brad Sherman introduced a bill that would direct the SEC to "revise any rule of the Commission relating to investment company registration statements to specify that, when calculating the fees and expenses of an Acquired Fund, the term Acquired Fund does not include a business development company."[36]

When the AFFE requirements were adopted in 2006 the SEC could not have anticipated the negative impact that the requirements would later have on BDCs. Notably, the "Cost-Benefit Analysis" section of the Funds of Funds Adopting Release states the SEC's belief that the AFFE requirements would not have "an adverse impact on capital formation."[37] This disconnect between the SEC's expectations and reality may be explained by the fact that BDCs lacked a strong voice when the AFFE requirements were first considered.

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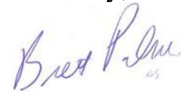
We would welcome the opportunity to meet with the SEC and discuss these issues further. Please contact SBIA's Executive Director, BDC Council, Tonnie Wybensinger, at [redacted]7 or [redacted] if we can provide additional assistance.

Sincerely,



Brett Palmer
President

cc: The Honorable Jay Clayton
The Honorable Caroline A. Crenshaw
The Honorable Allison Herren Lee
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia O. Blass
Director, Division of Investment Management

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[35] *Id.*

[36] Access to Small Business Investor Capital Act, H.R. 7375, 116th Cong. (2020), available at https://www.govtrack.us/congress/bills/116/hr7375.

[37] SEC, *Fund of Funds Investments*, IC Release No. 27399, 71 Fed. Reg. 36640 (June 20, 2006), available at https://www.sec.gov/rules/final/2006/33-8713.pdf.