TWO BETHESDA METRO CENTER
14th FLOOR
BETHESDA, MD 20814
TELEPHONE (301) 951-6122
FAX: (301) 654-6714
Info@AmericanCapital.com

January 7, 2005

Via Electronic Filing

Mr. Jonathan G. Katz, Secretary
U.S. Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: File Number S7-37-04

Dear Mr. Katz:

American Capital Strategies Ltd. (NASDAQ: ACAS) ("American Capital") appreciates the opportunity to comment on the Securities and Exchange Commission's (the "Commission") Proposed Rule: *Definition of Eligible Portfolio Company under the Investment Company Act of 1940* (the "proposed rule").[1]

American Capital is an internally managed, publicly traded investment company based in Maryland, which elected to be regulated as a business development company ("BDC") in 1997. It has capital resources in excess of $4.8 billion, and is the second largest BDC. American Capital invests in and sponsors management and employee buyouts, invests in private equity sponsored buyouts, and provides capital directly to private and small public companies. American Capital provides senior debt, mezzanine debt and equity to fund growth, acquisitions and recapitalizations.[2]

American Capital strongly supports the Commission's final adoption of the proposed rule as drafted. As the Commission observed in the release announcing the proposed rule, changes by the Federal Reserve Board to the rules concerning margin securities arguably had the unintended effect of precluding issuers of debt securities, whether or not listed on a stock exchange or the NASDAQ Stock Market, from qualifying as "eligible portfolio companies" under Section 2(a)(46) of the Investment Company Act of 1940 (the "1940 Act"). This technical flaw has created great uncertainty in the operation of BDCs, as it could be construed to restrict greatly the amounts and types of financing that a BDC is able to provide to the small, developing

[1] 69 Fed. Reg. 64816 (Nov. 8, 2004).
[2] *See generally* http://www.americancapital.com.

or financially troubled issuers that Congress intended to benefit from the availability of BDC financing. In light of this uncertainty, American Capital urges the Commission to adopt the proposed rule in its current form as promptly as possible.

American Capital commends the Commission for using its statutorily designated rulemaking authority to restore the definition of "eligible portfolio company" to encompass privately held and certain smaller publicly held domestic businesses, which were considered eligible portfolio companies at the time the Small Business Investment Incentive Act of 1980 ("SBIIA") was adopted, and to correct what we believe was an unintended change to the original concept of the SBIIA.[3] Accordingly, the proposed rule will, when adopted, further the goals of the SBIIA.

Below we have provided our comments to the proposed rule and respectfully submit them to the Commission for consideration.

A. Proposed Rule 2(a)-46(a)

American Capital strongly supports the prompt adoption of proposed Rule 2(a)-46(a). As noted in the Commission's release discussing the proposed rule, the statutory definition of "eligible portfolio company" included any issuer that does not have any class of securities with respect to which a member of a national securities exchange, broker or dealer may extend margin credit pursuant to Federal Reserve Board rules or regulations. At the time of adoption, this objective standard meant that eligible portfolio companies for a BDC included every private domestic business (and many public businesses) and reflected a good correlation to the types of businesses that Congress intended to benefit from BDC financing: companies without ready access to publicly raised capital.

A technical flaw in the definition of "eligible portfolio company" arose because of changes to margin regulations implemented by the Federal Reserve Board over the years and principally in 1998. Generally, the Federal Reserve Board amended its margin rules to, among other things, reduce the regulatory distinctions between broker-dealers and other lenders under the margin rules. In particular, the 1998 amendments expanded the definition of margin security to include any security that is not an equity security, even if not publicly offered.[4] These changes appear to have had the unintended effect of precluding essentially all issuers that have debt securities from qualifying as eligible portfolio companies for BDC investment purposes (absent

---

[3] *See* 15 U.S.C. § 80a-3 (2004).
[4] *See generally* 63 Fed. Reg. 2805 (1998).

qualifying as an "eligible portfolio company" through other means, such as control by the BDC alone or with a group). As a result, tens of thousands of companies, which had previously met the requirements to be "eligible portfolio companies," arguably no longer qualify because they have outstanding debt securities. Thus, this technicality, if applied in such a manner, has the effect of imposing substantial constraints on BDC investments, which are contrary to Congress' intent to make BDC financing available to domestic operating businesses without ready access to publicly raised capital.

Proposed Rule 2(a)-46(a) corrects this technical flaw by including within the definition of "eligible portfolio companies" domestic issuers that are not listed on a national securities exchange (an "Exchange") or traded on the NASDAQ Stock Market. If adopted, this rule would establish an objective standard that correlates to whether an issuer has access to publicly raised capital. We believe that the proposed rule is the best approach to restore immediately Congress' intent that BDC financing be available to private companies and public companies not listed on an Exchange or the NASDAQ Stock Market.[5]

We understand that the Commission has considered other alternatives, including those based on market capitalization as expressed in H.R. 3170, which passed in the House of Representatives on April 28, 2004. The Commission noted in the release announcing the proposed rule that adoption of such standards would require additional study and examination. We would strongly favor expanding the definition of "eligible portfolio companies" to include issuers listed on an Exchange or the NASDAQ Stock Market with a market capitalization of less than a specified amount.[6] However, we firmly believe that any study or examination of such a standard should not delay the swift implementation or the adoption of the proposed rule as it relates to entities that do not have any class of securities listed on an Exchange or the NASDAQ Stock Market.

The Commission requested comment on whether an alternative rule could be structured, based on listing standards of the Exchanges or the NASDAQ Stock Market, to establish whether an issuer would be an "eligible portfolio company" whether or not the issuer is actually publicly listed on an Exchange or the NASDAQ Stock Market. American Capital would oppose such an approach because it would not be an effective measure of whether an issuer could benefit from

---

[5] *Proposed Rule*: Definition of Eligible Portfolio Company under the Investment Company Act of 1940, SEC Rel. No. IC-26647; File Nos S7-37-04 (Nov. 8, 2004) (Proposal).

[6] In our view, Exchange and the NASDAQ Stock Market traded issuers with a market capitalization of up to $250,000,000, as set forth in HR 3170, would be an appropriate initial standard. We would also propose that this specified amount of market capitalization be adjusted annually by an index measuring the growth in the equity markets.

BDC financing. Such an approach would too narrowly construe Congress' intent in the SBIIA to provide financing to issuers without ready access to the public markets.[7] In fact, American Capital has financed smaller companies that were listed on the NASDAQ Stock Market, but which did not have ready access to capital. We could provide the Commission case studies on the investments if that would be helpful.

The minimum initial standards of the Exchanges and the NASDAQ Stock Market are relatively low and use of them would exclude companies that we believe Congress intended to be within the universe of companies eligible for BDC financing.[8] Under such a standard, many small or developing businesses that should have access to BDC financing would not meet the criteria of an eligible portfolio company. This might have the unintended consequence of allowing only the smallest companies to be eligible for BDC financing. Many small or developing companies, would have access to neither BDC financing nor meaningful access to the public capital markets because such companies, even if listed on an Exchange or the NASDAQ Stock Market, would most likely not attract significant interest from the public capital markets.

Moreover, tying the definition of eligible portfolio companies to market listing standards also could result in the substantially the same situation as was caused by the Federal Reserve Board changes to the margin securities regulations. As with the Federal Reserve Board, the Exchanges and the NASDAQ Stock Market have no particular interest in BDCs and, unlike the Commission, are not charged with ensuring that Congress' intent concerning BDC financing is fulfilled. Future changes in listing standards, made for an Exchange's or the NASDAQ Stock Market's own purposes, may well have the unintended consequence of greatly restricting the

---

[7] See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 23 (1980) (observing that 8,000 of 12,000 publicly held operating companies plus all privately held companies would be "eligible portfolio companies").

[8] For example, the minimum initial financial requirements for a company to have its securities traded over the NASDAQ Stock Market include: (1) stockholders equity of $5 million or $50 million market value of listed securities; (2) 1 million publicly held shares; and (3) $5 million in market value of the publicly held shares. A complete list of the NASDAQ Stock Market SmallCap Market Financial requirements is available at www.nasdaq.com/about/nasdaq_listing_req_fees.pdf.
The New York Stock Exchange ("NYSE") maintains initial listing standards that consider both quantitative and qualitative listing criteria. Among other things the NYSE's listing standards include: (1) 500 total shareholders; (2) market value for Initial Public Offerings of $60 Million and (3) 1,100,000 shares outstanding. A complete Listing Standards Guide for the NYSE is available at www.nyse.com/Frameset.html?displayPage =/listed/1022540125610.html.

definition of "eligible portfolio company" and the financing available to companies without ready access to public markets.

Additionally, the minimum quantitative standards for the Exchanges and the NASDAQ Stock Market establish a floor for listing, but they do not determine or even necessarily relate to, in and of themselves, whether a specific issuer will, in reality, have ready access to publicly raised capital. Many companies may meet the minimum initial quantitative listing standards of the Exchanges or the NASDAQ Stock Market based on their size or capital structure, but are not able to obtain publicly-raised capital because, in reality, there is no ready market or interest in their securities. Such companies should not be restricted from BDC financing because they are exactly the types of companies that Congress intended to benefit from the SBIIA through the reference to the Federal Reserve Board's margin securities rules.[9]

By excluding issuers that choose to be and can remain publicly listed on an Exchange or the NASDAQ Stock Market, proposed Rule 2(a)-46(a) would, in effect, take into account the vagaries of the market for initial public offerings more readily than a standard based on minimum quantitative listing qualifications. Accordingly, American Capital believes the Commission's proposed rule more appropriately describes the category of issuers that Congress intended for BDC investment in the SBIIA than a standard based on minimum listing standards would.[10]

Without the Commission's proposed amendments, the 1998 Federal Reserve Board amendments to the margin rules leave a significant gap in the availability of financing that prevents most issuers, both public and private, that do not have ready access to public capital markets, from gaining access to BDC financing. It also creates ambiguity and constraints on the operation of a BDC that are antithetical to the Congressional intent.

---

[9] See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 30 (1980) ("Companies whose securities are eligible for margin purchase generally are reasonably mature, at least from the standpoint that they would generally have access to conventional public capital markets").

[10] The Commission also requests comment on whether the Commission should exclude from the definition of "eligible portfolio company" any issuer that would meet the initial listing standards, quantitative and qualitative, of an Exchange or NASDAQ Stock Market, regardless whether the issuer enters a listing agreement with the Exchange or NASDAQ Stock Market. For the reasons noted above, minimum listing standards, alone, are not an effective method of determining whether an issuer would, in fact, have ready access to public capital. Moreover, such an approach would too narrowly construe Congress' intent to permit regarding the types of issuers that would benefit from BDC financing. See H.R. Rep. 1341 at 23.

For the reasons discussed above, we strongly support the Commission's proposal to amend the definition of eligible portfolio company to include issuers that are not listed on any Exchanges or the NASDAQ Stock Market. American Capital urges the Commission to act promptly to correct the technical flaw created by the 1998 Federal Reserve Board amendments to the margin rules by adopting the proposed rule in its current form.

B. Proposed Rule 55a-1

American Capital supports proposed rule 55a-1, permitting a BDC to invest in certain follow-on investments in issuers that were eligible portfolio companies when the BDC made its initial investment(s), but are no longer eligible portfolio companies as a result of having a listed class of securities on the Exchanges or the NASDAQ Stock Market. The proposed Rule is an important corollary to proposed Rule 2(a)-46(a). American Capital agrees with the Commission's view that there should not be any time limitations on making follow-on investments in publicly listed companies where the prescribed conditions of Section 55(a)(1) of Investment Company Act of 1940 are met. Any arbitrary and inflexible time limitation would be overly restrictive and may not be appropriate for all investment situations pertaining to BDCs. The BDC should have maximum flexibility to manage its investments and support its portfolio companies to the benefit of its shareholders. Any such time limitations would potentially interfere with a BDCs ability to manage its investments in the best interest of its shareholders and would be inconsistent with the purposes and policies of the Investment Company Act of 1940, as amended. Accordingly, we support Proposed Rule 55a-1 in its current form.

*** * ***

We appreciate the opportunity to express our thoughts on the proposed rule and we urge its prompt adoption. If you have any further questions or need additional information please contact the undersigned.

Very truly yours,

/s/ Samuel A. Flax

Samuel A. Flax
Executive Vice President and General Counsel