TESTIMONY OF

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BEFORE THE

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GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

" LEGISLATIVE PROPOSALS TO MODERNIZE BUSINESS DEVELOPMENT COMPANIES AND EXPAND INVESTMENT OPPORTUNITIES"

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I. Introduction

Chairman Garrett, Ranking Member Maloney and members of the Sub-Committee, thank you for the opportunity to testify today. My name is Michael Arougheti and I am the Co-Chairman of the Board of Directors of Ares Capital Corporation, an SEC registered Business Development Company, or "BDC", and one of the largest non-bank providers of capital to small- and medium-sized American companies – the backbone of the U.S. economy. Ares Capital Corporation is publicly-traded on the NASDAQ National Market and is currently the largest publicly-traded BDC by both market capitalization and assets. Since our IPO in 2004 through March 31, 2015, we have invested more than $20 billion in more than 650 transactions with hundreds of small and medium sized American companies, in the process creating tens of thousands of new jobs and providing capital to growing businesses who were unable to access capital through commercial banks or other traditional financing sources.

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". The stated objective of BDCs was to encourage the establishment of new market vehicles to invest in, and increase the flow of capital to, private businesses. By mandate, BDC's are also required to provide managerial assistance to their portfolio companies. Uniquely, the BDC model gives ordinary investors the opportunity to finance small and medium size companies – effectively "Main Street funding Main Street".

Today there are 57 publicly-traded BDCs with an aggregate market capitalization of more than $45 billion and approximately $77 billion in assets. This in the aggregate would place the **entire** BDC industry as the 30th largest bank in the country by assets.[1] While the scope of BDC's investments may vary, all BDCs share a common investment objective of improving capital access. As commercial banks and other traditional financing sources continue to retrench from the business of providing loans to small and medium size companies, BDCs now find themselves at the forefront of the effort to address the unmet capital needs of these companies.

Today, the middle market sector of the economy is responsible for one-third of private sector GDP[2] and BDCs have grown as commercial banks have withdrawn from lending to this sector. Specifically, middle market leveraged lending by commercial banks has decreased from a peak of 60% in 2001 to 1.5% in Q1 2015.[3] Perhaps the most striking example of this retrenchment is GE Capital's recently announced exit from the U.S. middle market lending space. As the seventh largest bank in the United States, GE Capital provided a significant amount of capital to small and medium sized businesses and its exit from this market will surely have a significant impact on the future availability of capital to support the growth of these businesses and the jobs that they provide.

The impact of BDC's on small and medium sized businesses has been tangible and meaningful. By way of example, in 2008 Ares Capital Corporation made an initial investment in OTG Management Inc., a founder-owned operator of full service sit-down and quick-service restaurants, bars, lounges, gourmet markets, and news and gift shops based in airports in the

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[1] Source: Federal Reserve Statistical Release, December 31, 2014, www.federalreserve.gov/Releases/Lbr/current/default.htm

[2] Source: National Center for the Middle Market www.middlemarketcenter.org/performance-data-on-the-middle-market.

[3] Source: Middle Market Quarterly Review 1Q14 S&P Capital IQ; 1Q 2015 High End Middle Market Lending Review: S&P Capital IQ

United States. and Canada. OTG was awarded a contract to build-out and operate the food and beverage concessions at JetBlue's new Terminal 5 at New York's JFK International Airport and needed to raise capital to complete the construction plan. However, OTG was a small company with limited operating history at the time and therefore, financing from a traditional senior debt provider or a private equity firm was not an option to provide what OTG was looking for. Traditional senior debt providers were not an option as their proposed capital was limited, inflexible, had a low tolerance for risk, and as OTG won new contracts, they could not provide a sufficient amount of incremental capital to fund these future activities. Similarly, private equity sources of capital were not an option as they wanted to be able to force liquidity within a certain time frame, which was incompatible with a private company that wished to preserve autonomy and invest in growth over the long term. Because BDCs such as Ares Capital Corporation are "permanent capital" vehicles, they often have a longer investment horizon and can provide more flexible capital to companies like OTG. Ares Capital Corporation not only provided capital for the build-out of JetBlue's Terminal 5 at New York's JFK International Airport, but has since become a strategic financing partner to the Company and provided capital to support multiple airport projects around the country. In addition, Ares Capital Corporation took seats on OTG's board of directors and has provided valuable strategic advice and support to the company as it grew.

While the BDC industry continues to grow, I strongly believe that we can expand our scope and do more to fulfill our policy mandate. To that end, I am here today along with others in the BDC industry to express support for proposed legislation that seeks to make common sense, prudent changes to the Investment Company Act of 1940 in order to enable BDCs to more easily raise and deploy capital to small and medium size businesses. **<u>It is important to note that BDCs are not seeking any government or taxpayer support or subsidy</u>**. The BDC industry is simply asking Congress to modernize the applicable regulatory framework so that BDCs can more easily fulfill their Congressional mandate.

II. <u>Policy Challenges / Proposed Policy Solutions</u>

BDCs are heavily regulated by the SEC and appropriately, the activities of BDCs are fully transparent to regulators, investors and portfolio companies. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. These disclosure and other regulatory requirements are extensive and include, among other things, a requirement that BDCs publish a quarterly summary of each investment held by a BDC and the fair value of such investment. This is a significantly greater degree of transparency than that found in other financial services models.

While we certainly believe in the importance of appropriate regulation, many of the challenges faced by BDCs in increasing the amount of capital that they can raise and deploy are a consequence of where BDCs sit in the regulatory framework. BDCs are more akin to operating companies such as banks and other commercial lenders, yet are regulated as mutual funds. Consequently, BDCs must often play the part of the proverbial "square peg in a round hole".

So, the question then becomes how to enable BDCs to fulfill their Congressional mandate of being an active provider of capital to small and medium sized companies, while remaining appropriately regulated and transparent?

The answer – begin the process of modernizing the regulatory framework with a handful of modest, common sense changes. Clearly, the world is a much different place than it was in 1980 when Congress created BDCs.

One of the important lessons learned by BDCs during the "Great Recession" was that during a downturn, certain parts of the existing regulatory framework applicable to BDCs constrained their mission to deploy capital to small and medium sized companies. As you know, in the last Congress the House Financial Services Committee passed H.R. 1800, which sought to mitigate/eliminate a number of these structural constraints.

Today, I am here to offer support for the draft of the "Small Business Credit Availability Act" being offered by Mr. Mulvaney. This draft builds on H.R. 1800 and other bipartisan efforts in the previous Congress to modernize BDC legislation. In short, the proposed bill seeks to enable BDC's to "do more" than they are currently able to in terms of the number of companies that they can lend to, the types of investments they can make and the amount of capital that they can raise and deploy. At the same time, the proposed bill contains provisions designed to ensure that BDCs continue to be appropriately regulated and subject to stringent standards regarding transparency and shareholder protection.

The proposed bill contains five provisions, each of which we believe will enable BDCs to more effectively fulfill their Congressional mandate today and in the future .

- **<u>First</u>**, like H.R. 1800, the proposed bill contemplates an increase in the BDC asset coverage test from 200% to 150%, thereby broadening the universe of potential borrowers that can access loans from a BDC. However, under the proposed bill such an increase would now be subject to the following shareholder-friendly conditions:
    - Prior to adopting such increase, the BDC must receive the approval of:
        - At least a majority of its disinterested directors, in which case such an increase would become effective one year after such approval[4]; **<u>or</u>**
        - More than 50% of the votes cast at an annual or special meeting of its shareholders, in which case such an increase would become effective immediately following such approval.
    - The BDC must file a Current Report on Form 8-K disclosing the effective date of such approval as well as information relating to the BDCs outstanding senior securities and its asset coverage ratio. The same disclosure, along with the principal risk factors associated with any increased leverage, must also be included in a BDC's periodic filings under the Securities Exchange Act of 1934.

[4] For BDCs that are not publicly traded on a national exchange, such approval shall not become effective until such BDC offers to repurchase from each shareholder the equity securities held by such shareholder as of the board approval date, with 25% of such equity securities to be repurchased in each of the four quarters following such board approval date.

We do not believe that the proposed change introduces more risk. Rather, it should allow BDC's to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test actually forces BDC's to invest in riskier, higher-yielding securities in order to meet the dividend requirements of their shareholders. This potential "de-risking" is further supported by the strong underlying performance of the loan asset class. For example, during the period from our IPO through March 31, 2015, ARCC's average non-accrual rate on first lien senior secured loans was 2.19% while the average default rate of the S&P LSTA Leveraged Loan Index for first lien senior secured loans for that same period was 2.53%.[5] Similarly, since inception BDCs have generated a cumulative gain/loss rate of negative 17 bps, outperforming banks by 219 bps.[6] We believe that this proposed change will benefit borrowers through greater financing alternatives and a reduced cost of capital and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios. In addition, the markets have already acknowledged a willingness to provide increased leverage to acquire these higher credit quality assets.

In addition, this proposed change would apply to BDCs the same leverage ratio as the leverage ratio for Small Business Investment Companies but, unlike SBICs, without putting any government capital at risk. This seems prudent, consistent with other legislation that this sub-committee has passed and, as I noted, benefits both small and medium sized companies and shareholders without any government or taxpayer subsidy. Given that the House Small Business Committee just last week passed bipartisan legislation increasing the size of the SBIC program, the requested modifications to the regulatory framework governing BDCs certainly seems reasonable. This proposed change is also extremely modest given that banks customarily incur leverage of 10:1 and greater.

An increase in this ratio will also provide additional "cushion" given the requirement that BDC's must "mark to market" their loans each quarter. Specifically, in the event of falling asset values in the overall market as we saw during the Great Recession, unlike banks and other commercial finance companies BDCs are generally required to write down the value of certain of their otherwise performing assets. Currently, most BDCs have an average leverage ratio of 0.5x-0.75x, reflecting a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep drop in asset values. However, the maintenance of such a cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress. This additional cushion would provide BDCs with the ability to deploy more capital in the ordinary course and through market cycles.

[5] Source: S&P LCD data for LSTA Leveraged Loan Index. Calculated as the average of last twelve months rolling monthly first lien default rates over the period from October 2004 through March 2015.
[6] The 2Q 2015 BDC Scorecard, Wells Fargo

Finally, given the transparency required of BDCs in their SEC disclosure documents, which has been further enhanced in the proposed legislation, shareholders will be clearly informed (as they are now) of the amount of leverage that BDCs can incur and any potential risks to them associated with such leverage.

- **Second**, the proposed bill would allow BDCs to issue multiple classes of preferred stock and, solely for preferred stock issued to Qualified Institutional Buyers (and not retail investors), eliminate the requirement that holders of preferred stock have board representation. During the last downturn, many BDCs were challenged with respect to issuing common equity at a price below net asset value. Had BDCs been able to raise capital during the post 2008 period by issuing preferred shares as equity, many more loans could have been made to cash-starved companies to enable them to retain employees and, in some instances, to remain in business.

- **Third**, the proposed bill directs the SEC to make specific technical amendments to certain securities offering rules applicable to BDCs. Currently, despite the need for regular access to the capital markets, BDCs are the only seasoned issuers required to comply with certain provisions of the 1933 Act which, in turn, makes raising capital cumbersome and inefficient. These rule changes would merely place BDCs on equal footing with non-BDC's without any accompanying decrease in transparency or shareholder protection.

- **Fourth**, the proposed bill would allow BDCs to own registered investment advisers, which as a technical matter is currently prohibited under the 1940 Act. Investments in RIAs enable money to be raised from third party investors which, in turn, can be deployed to small and medium-sized companies.

- **Fifth**, the proposed bill would offer welcome flexibility for BDCs to invest in entities currently limited by the existing 30% basket. For example, a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context may seem arbitrary. Of note, this provision of the draft legislation would **not** allow the amount of the incremental increase in the 30% basket to be invested in private equity funds, hedge funds or collateralized loan obligations (CLOs).

III. Closing Remarks

In conclusion, we believe that the time is right to modernize regulations governing BDCs and pass legislation which would allow BDC's to increase capital flows to America's small and medium size companies, spur economic growth and create jobs. It is clear that banks have left this space and will not return. We are hopeful that there will once again be a bi-partisan focus on this important initiative, and look forward to working with the Committee in moving this bill forward.

On behalf of the entire BDC sector, I'd like thank Representative Mulvaney for his efforts and urge the sub-Committee to act favorably on a BDC modernization bill. Again, I appreciate the opportunity to testify today and would be pleased to answer any questions.