Hearing on "Legislative Proposals to Modernize Business Development Companies and Expand Investment Opportunities"
House Committee on Financial Services
Subcommittee on Capital Markets & Government Sponsored Enterprises
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On behalf of the Small Business Investor Alliance
www.SBIA.org

Good Afternoon Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee on Capital Markets and Government Sponsored Enterprises. I appreciate the opportunity to testify today on behalf of the Small Business Investor Alliance (SBIA), which represents a significant proportion of the Business Development Company (BDC) industry. SBIA's BDC members provide vital capital to small and medium sized businesses nationwide, resulting in job creation and economic growth. Since our organization was established in 1958, our mission has been to ensure a healthy and vibrant market for small and mid-size businesses.

Background on Main Street Capital

My name is Vince Foster and I am the Chairman, President, and CEO of Main Street Capital Corporation (Main Street), a SEC-registered Business Development Company (BDC) based in Houston, Texas. Main Street is publicly-traded on the New York Stock Exchange (NYSE: MAIN) and is currently the 6th largest BDC by market capitalization and assets. Since our IPO in 2007, we have invested more than $4 billion in more than 400 small and mid-sized companies: in the process, creating or retaining many jobs and providing capital to growing businesses that were unable to access capital through commercial banks or other traditional financing sources.

At Main Street, our primary focus is providing long-term debt and equity capital to private U.S. companies operating in what we refer to as the lower middle market. We also provide debt capital to middle market companies. Our portfolio investments are typically made to support management buyouts, recapitalizations, growth financings, refinancings, and acquisitions of companies that operate in diverse industry sectors. We seek to partner with entrepreneurs, business owners, and management teams and, generally, provide "one stop" financing alternatives within our lower middle market portfolio. Our lower middle market companies have annual revenues between $10 million and $150 million, while our middle market debt investments are made in businesses that are generally larger in size than our lower middle market portfolio companies.

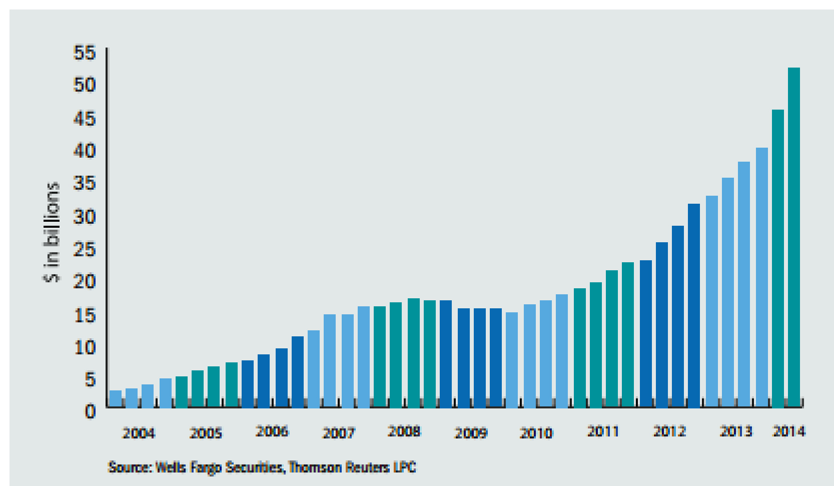
We currently have investments in 70 lower middle market companies, nearly all of which include debt and equity investments which comprise roughly half of our investment portfolio. Over half of these lower middle market companies have annual revenues less than $25 million, and our average equity ownership position in our lower middle market investments is 36%. Since the mid-1990s, we, through Main Street and its predecessor funds, have founded, purchased, or financed lower middle market investments in over 200 companies in numerous industries.

<u>The BDC Sector is Growing and BDCs are a Positive Force in Providing Capital to Small and Mid-Size Businesses</u>

BDCs were created by Congress in 1980 to enhance capital access to small- and medium-sized businesses and to create the opportunity for the general public to get access to private equity and venture capital-like returns. BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to rely on accessing capital from traditional sources such as banks. Pursuant to applicable regulations, BDCs are required to invest at least 70% of their assets in small- and medium-sized U.S. operating businesses (eligible portfolio companies). For most BDCs, the percentage of eligible portfolio companies is well above 70%.

Despite an outdated regulatory regime which has been in place since the early 1980s, the number of BDCs has grown significantly since 2004. This growth accelerated following the downturn of the economy experienced after the 2008-2009 economic recession, where BDCs provided a significant source of capital for small and mid-size businesses that were starved of capital. Currently, there are over 80 BDCs in the United States and BDC loan balances have more than tripled since 2008. The chart below shows the rapid growth of exchange-traded BDC loan balances since 2010, illustrating the significant growth in BDC lending to middle market companies and the strong interest of investors to participate in this space.

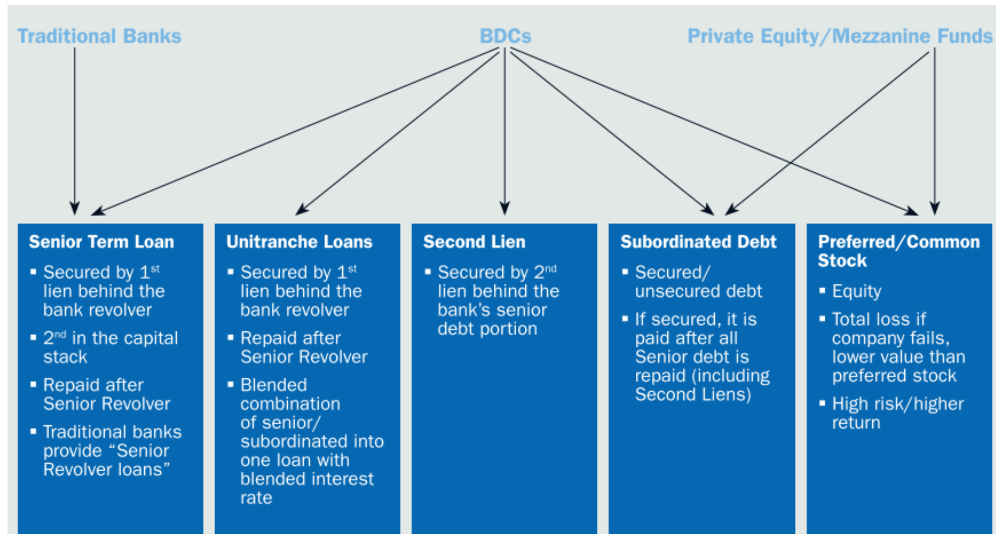
Estimated Publicly Traded BDC Loan Balances (Nov. 2014)



Source: Wells Fargo Securities, Thomson Reuters LPC

BDCs have various investment strategies, including providing flexible debt and equity solutions to small and mid-size companies. BDCs typically make secured and unsecured loans between $10 and $50 million to middle market companies, returning strong returns to their shareholders.

This financing helps small and mid-size businesses create jobs and finance new capital projects such as land, equipment, and factories. At the same time, average Americans are able to invest in these BDCs and earn healthy returns in their investment portfolios.



<u>Main Street Investments Across the United States</u>

Our lower middle market portfolio companies operate across many diverse industry groups and are headquartered in 24 different states. To illustrate this diversity: we have funded two of the fastest growing technology companies in Eugene, Oregon; the largest privately-owned jewelry store chain in the Rocky Mountains, headquartered in Twin Falls, Idaho; one of the largest Goodyear tire retailers in the U.S., headquartered in Austin, Texas; the leading micro-irrigation design and installation company in the San Joaquin valley in central California; the leading FBO at the Indianapolis airport; one of the largest fully integrated precast concrete companies in Texas, headquartered in San Antonio; and one of only two independent synthetic rubber producers of Styrene-Butadiene-Rubber (SBR) in the U.S., headquartered in Baton Rouge, Louisiana, just to name a few.

We note that the Committee's membership is currently represented by 24 states. As of today, we have investments in lower middle market businesses headquartered in 15 of these states. These investments generally consist of both debt and equity in each company, which would not otherwise be available from traditional sources such as local commercial banks or traditional private equity funds. These companies range from GRT Rubber Technologies (www.grtrubber.com) in Paragould, Arkansas, which was founded in the 1880s and

manufactures engineered rubber products including conveyor belts; to Bridge Capital Solutions (www.bridgecapitalsolutionscorp.com) in Hauppauge, New York, which operates Long Island's only licensed commercial check cashing service, serving small businesses in New York.

BDCs have provided significant investment to small and mid-size businesses across the United States, in almost every state, as illustrated in the map below.

State by State BDCs Total Exposure (In Millions)

Data Provided by Wells Fargo Securities, LLC

<u>BDCs are Highly Regulated and Provide Transparency to Investors</u>

BDCs are heavily regulated by the Securities and Exchange Commission (SEC or Commission). When BDCs were created in 1980, they were placed in a unique and somewhat unwieldy structure of being governed like a mutual fund through the Investment Company Act of 1940 ('40 Act), while also having many requirements imposed on them similar to operating companies (such as making periodic 10-Q and 10-K filings with the Commission). Under the '40 Act, BDCs must offer to provide significant managerial assistance to the companies they invest in, helping

these small and mid-size companies improve their products and grow their businesses. Unlike a mutual fund, BDCs are generally not buying publicly traded stocks, but are instead investing in largely illiquid small- and medium-sized businesses. With this in mind, BDCs are active participants in providing non-financial resources to help their investments grow.

BDCs are extremely transparent in their operations and investments. The public can readily look up all of the investments that a BDC has made. BDCs must register their shares with the SEC and engage in lengthy, transparent, and significant disclosure on their operations and investment activities to ensure their investors are fully informed. BDCs, through the filing of registration statements and periodic public filings (8-K, 10-K and 10-Q) with the Commission, make significant disclosures about their business operations, leverage loads, and the investments they make – informing shareholders about the types of investments and loans they are making to these small and mid-size businesses, allowing them to make an educated decision on whether to invest.

While BDCs have extensive oversight and disclosure requirements, providing clarity and transparency for investors, the current regulatory regime for BDCs is outdated and unnecessarily burdensome. These burdens make the BDC capital raising process less flexible, less efficient, and more expensive than necessary, while providing little improvement to investor protection or additional transparency as a result. Modernizing BDC regulations will help support American jobs and foster economic growth by improving access to the public capital markets for BDCs. It will also free up significant resources at the SEC, which can be utilized more effectively to protect investors. The goal is an efficient regulatory system that maintains investor protections.

In late 2005, the Commission implemented a significant "Securities Offering Reform" which was a sweeping modernization of the registered offering process and rules for public companies. Unfortunately, there was no voice for the few BDCs in the market at the time and reforms were not applied to BDCs. This left BDCs on an uneven playing field with other public companies seeking to access the capital markets. The SEC has failed to modernize the rules for BDCs despite a call to action by the BDC community on numerous occasions, most recently in an October 2013 letter from 24 BDCs spearheaded by SBIA. As a result, the industry is seeking Congressional help to provide BDCs the same offering rules as other public companies.

SBIA's Comments on the Discussion Draft of "The Small Business Credit Availability Act"

I would like to thank the Members of the House Subcommittee on Capital Markets and Government Sponsored Enterprises for working in a bipartisan manner to produce a discussion draft on BDC legislation, entitled the "Small Business Credit Availability Act." I want to especially thank Chairman Scott Garrett, Congressman Mick Mulvaney (R-SC), and Congresswoman Carolyn Maloney (D-NY) for their efforts.

My comments are representative of the SBIA membership which consists of over 30 BDCs investing across the country. The purpose of the legislation is to improve the ability of BDCs to fulfill their core mission of providing necessary capital and expertise to small and mid-size companies. The legislation makes a number of significant and necessary changes to modernize the regulation of BDCs and increase access to capital while continuing to preserve investor protections. The discussion draft has made a number of improvements from previous legislation and addressed issues that have come up in previous testimony. The discussion draft is a strong step in the right direction and we appreciate the opportunity to work with you to improve and finalize this legislation to ensure it is worthy of a timely markup and passage.

The Committee Should Adopt the Necessary Changes to Streamline BDC Offering and Proxy Rules in Section 4 of the Discussion Draft

Section 4 of the *Small Business Credit Availability Act* amends the '40 Act and certain other SEC rules and regulations to make necessary changes to streamline the offering, filing, and registration processes for BDCs at the SEC, eliminating unnecessary regulatory burdens, and providing offering standards consistent with other traditional public companies. The offering, filing, and registration reforms are particularly imperative for smaller BDCs, which will pay disproportionately higher costs to handle the enormous amount of paperwork required under the current BDC regulatory regime. It is extremely important for small BDCs to have a streamlined, efficient regulatory regime that removes unnecessary compliance costs and focuses the BDCs attention on investing in small and mid-size companies across the country.

The reforms to the offering and proxy rules in this Section contain over a dozen important regulatory reform changes that will save firms hundreds of thousands of dollars, streamline the offering process to make it faster and more efficient, and improve the ability of investors to access information and research from BDCs and independent parties. For example, this legislation allows BDCs to utilize "incorporation by reference," which allows them to cite information in previous filings, rather than having to include the exact same information again in a new filing. This provision will streamline disclosure requirements and reduce burdensome, duplicative regulatory paperwork for BDCs, while still ensuring investors receive the relevant and necessary disclosures. Investors would benefit from having a streamlined filing to review, rather than sifting through hundreds of pages of duplicative information.

Another important provision from Section 4 would allow BDCs to file automatic shelf registration statements and permit BDCs to qualify for Well Known Seasoned Issuer (WKSI) status. These changes will permit BDCs that have a lengthy track record in the marketplace, and the confidence of investors, to offer their securities with more flexibility and efficiency to shift with market demands and changes. Furthermore, these changes to the regulations would eliminate the requirement for BDCs to mail lengthy prospectuses to investors and elect to only

send these documents when investors wish to receive them. This is a common-sense solution that will save thousands of dollars in delivery costs, and save investors from having to accept lengthy documents that they may never intend to read. The changes in Section 4 are critical for investors and BDCs alike and should be included in any final bill that is introduced during this Congress.

The Committee Should Adopt Provisions in the Discussion Draft that Expand Access to Capital for BDCs

Section 3 of the *Small Business Credit Availability Act* will provide BDCs the option to deploy significantly more capital to small- and medium-sized businesses by changing what is known as the "asset coverage ratio." BDCs are currently limited to a 1:1 debt-to-equity ratio as opposed to banks and other financial vehicles that are often leveraged at a 9:1 ratio or higher. Allowing a the option for a modest increase in this leverage to 2:1 would enable BDCs to deploy significantly more capital to small and mid-size businesses. Simultaneously, BDCs will be able to reduce the risk in their portfolios, as they can invest in lower yielding, lower risk investments and still generate valuable returns and dividends to their shareholders. To be clear, this provision does not automatically increase leverage. It gives BDCs a regulated option to pursue increased leverage, but subject to investor protections and market constraints.

We believe the provisions in the legislation add new safeguards for BDC investors and ensure that investors will be sufficiently informed about leverage levels BDCs are taking on. The discussion draft provides *two options* for BDCs to increase their leverage. Under the *first* option, the BDC may conduct a vote of their Board of Directors, including the independent directors, with a 12 month waiting period after this vote. After 12 months, the BDC may access the increased leverage. Under the *second* option, the BDC may elect to conduct a shareholder vote. The vote may be held at an annual or special meeting, there must be a quorum, and more than 50% of shareholders must vote in favor of the increased leverage. After the vote on the second option, the BDC may access leverage immediately. If a BDC wishes to utilize the *first* option and is non-listed (i.e., not traded on a national stock exchange), it must provide a redemption facility to allow those investors to exit the BDC if they choose, at a reasonable price.

This process is well tailored in that it provides adequate time and means for BDC shareholders to exit or sell their shares in the BDC, or the ability to vote on the leverage change. Additionally, BDCs must notify the SEC and investors by filing an 8-K within five days of the board vote, place a public notice on the BDC's website, and disclose in their periodic filings that the change to the asset coverage ratio has been approved. These are meaningful investor protections and we support their inclusion.

The Committee Should Retain the Ability for BDCs to Own Investment Advisers in the Legislation

Section 2 of the *Small Business Credit Availability Act* makes a variety of changes that expand the flexibility of the types of companies in which BDCs can invest. The first change permits BDCs to own or acquire securities or other interests in registered investment advisers or other advisers to investment companies. The SEC has routinely provided no-action or exemptive relief to BDCs, including to Main Street, by permitting the ownership of investment advisers, thereby avoiding the BDC itself from having to serve as an investment adviser in a particular investment. Given the pervasiveness of SEC relief, this provision will standardize the practice and significantly increase the transparency afforded to investors in BDCs. It will also reduce the burden on SEC staff and resources in responding to relief requests by BDCs, a significant burden due to this rapidly growing industry.

Expanding "Eligible Portfolio Companies"

BDCs must invest at least 70% of their investments in "eligible portfolio companies." Generally, these are operating companies and the types of businesses BDCs were created to help. The legislation will expand the definition of eligible portfolio companies to include new companies previously excluded from the definition. The legislation places a 50% cap of BDC total assets on these new eligible portfolio companies.

Upon release of the discussion draft, SBIA shared the language with its members as well as with shareholders and analysts who cover the BDC sector. This language reflects improvements over similar legislation that was introduced in previous years. Unlike the previously mentioned reforms that had overwhelming consensus and support, this expansion is generally not a priority for most SBIA members. For those that are most interested, there are very differing views on the merits. Having only had the discussion draft for a few days, the closest thing to uniformity on this issue is that this section should be modified and tightened. With a little more time to contemplate the long term impacts on the industry and to hear their investors' thoughts on the proposal, there will be greater consensus from BDCs that we will promptly share with the Committee. We look forward to working with the Committee to offer a workable adjustment to this provision quickly to help BDCs maintain a healthy market and continue to serve their mission and policy mandate.

Closing Remarks

I want to share the sentiments of many in the BDC industry by thanking the Committee again for holding this hearing, and I am encouraged by the bi-partisan efforts in moving forward this

legislation. The Committee should act as soon as possible to pass these needed reforms to improve the capital formation process for BDCs and by doing aid small- and medium-sized businesses. We stand ready to answer any questions you have and to be a resource for you and your staff as you work out the final language of the *Small Business Credit Availability Act*.

Biography of Vincent D. Foster

Vincent D. Foster has served as Chairman and CEO of Houston-based Main Street Capital Corporation (NYSE:MAIN) since its IPO in 2007 and as its President since 2012. He has also been a member of Main Street's Investment Committee since its formation in 2007 and a member of its Credit Committee since its formation in 2011. Main Street is a Business Development Company focused on providing debt and equity capital to middle and lower middle market U.S. companies. Its investment operations include two Small Business Investment Companies, which are licensed by the U.S. Small Business Administration (SBA), and it has capital under management of $3 billion. Main Street was awarded the "2011 Small Business Investment Company of the Year" by the SBA. Main Street, under Mr. Foster's leadership, operated several investment funds prior to its IPO dating back to the mid-1990's.

Mr. Foster serves on the boards of Houston-based Quanta Services, Inc. (NYSE:PWR) and Sugar Land, Texas-based Team Industrial Services, Inc. (NYSE:TISI). Quanta Services, co-founded by a predecessor Main Street fund, and an S&P 500 Company, is a leading provider of specialized contracting services, delivering infrastructure solutions for the electric power and oil and gas industries in North America and internationally. Mr. Foster served as Quanta Services' Chairman from its founding in 1997 until 2002, and serves on its Audit and Investment Committees. Team Industrial Services is a leading provider of industrial services related to the maintenance and installation of pressurized piping systems and processes and inspection. Mr. Foster serves as Chairman of Team Industrial Services' Audit Committee.

Over the last 15 years, Mr. Foster served on numerous other public and private company boards of directors and co-founded the Houston Chapter of the National Association of Corporate Directors, serving on its board from 2004-2011.

Prior to his association with Main Street, Mr. Foster, a CPA, had a 19 year career with Arthur Andersen, including 9 years as a partner of Andersen Worldwide. Mr. Foster directed Andersen's Corporate Finance and Mergers and Acquisitions practice for the Southwest U.S.

Mr. Foster was recognized for the Ernst & Young Entrepreneur of the Year 2008 Award in the financial services category in the Houston & Gulf Coast Area. The program honors entrepreneurs who have demonstrated exceptionality in innovation, financial performance and personal commitment to their businesses and communities.

Mr. Foster graduated from Michigan State University in 1978 where he earned his bachelor's degree in Business Administration (majoring in Accounting). He also earned a JD degree from Wayne State University Law School.