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before the

Subcommittee on
Capital Markets, Securities and Investment

Committee on Financial Services

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Legislative Proposals to Improve Small Businesses' and Communities' Access to Capital

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Chairman Huizenga, Ranking Member Maloney, members of the Subcommittee, it is an honor and a privilege to appear before the Subcommittee today. Thank you for this opportunity. I am the Founder and President of Fund Democracy, a nonprofit advocacy group for investors, and a Professor of Law at the University of Mississippi School of Law.

This testimony discusses aspects of three bills before the Subcommittee: the Consumer Financial Choice and Capital Markets Protection Act of 2017; the Expanding Investment Opportunities Act; and the Small Business Credit Availability Act. In summary, the third bill recognizes that business development companies ("BDCs") are a form of special purpose investment company, both in terms of their unique status as reporting companies under the Exchange Act and their important role in providing credit to small- and mid-sized U.S. companies. The U.S. Securities and Exchange Commission has also recognized that BDCs are a different kind of investment company and, accordingly, has granted carefully crafted no-action relief from certain offering requirements and restrictions.

I agree that the SEC's positions should be codified to allow BDCs to incorporate filings by reference, clarify their ability to conduct shelf registrations and grant automatic effectiveness to registration statements that reflect only nonmaterial changes. However, Congress should reconsider amending the legislation by simply requiring the SEC to adopt and/or amend its rules. Otherwise, there is a risk that the effect of the bill will be to create conflicts and ambiguity in what is currently a delicately balanced set of complex, interlocking rules.

The foregoing reforms identify actual problems that have been appropriately raised by the industry and refined and vetted in Congressional hearings, notwithstanding that the problems would be more efficiently and effectively resolved by requiring guided SEC rulemaking. In my opinion, the remaining BDC offering reforms in the bill, and especially the closed-end fund ("CEF") offering reforms in the Expanding Investment Opportunities Act, do not reflect a considered solution to identified problems in offering regulation. These offering reforms generally cut and paste rules adopted under the Securities Act that were specifically designed for operating companies and apply them wholesale to two type of investment companies for which they are a poor fit. Under the

bills, the set of rules under which BDC and CEF offerings are conducted, and that are the actual source of any problems that the industry may have with securities offerings, would remain unchanged. This approach would create parallel regulatory regimes for BDC and CEF offerings that would create needless complexity and confusion.

This is especially true for closed-end funds. Closed-end funds are registered investment companies; BDCS, in contrast, are reporting companies, a kind of hybrid issuer. Reporting companies such as BDCs are subject to the full set of annual reports, quarterly reports and other filing requirements that apply to other operating companies. Closed-end funds are not subject to these rules. They are not hybrid issuers, but pure bred registered investment companies. Nor do CEFs serve a particular purpose in making capital available to what Congress views as an underserved capital market. There is no understanding that CEFs should receive special breaks, or a parallel offering regime, as a kind of quid pro quo. Unlike operating companies, which directly increase net social wealth, CEFs serve no ultimate end other than as facilitators of capital formation. Any perceived parallel between CEFs and BDCs does not reflect reality. There are good reasons that CEFs are less popular investment vehicles than mutual funds and exchange-traded funds, and those reasons are not regulatory. And if there are regulatory concerns, they should be addressed by dealing with their source, which lies in the rules under which they currently operate.

The bills would increase the amount of leverage that BDCs may use, which would make more capital available to the capital market they serve, but if this, alone, were a sufficient reason to increase the current 1:1 leverage limit, then there would no reason to have a leverage limit at all. Raising the limit – indeed, lowering the limit or setting any limit – can only be assessed if the costs and benefits of different levels of leverage are understood and should be implemented only if the benefits of any change exceeds the costs. I have previously testified before this Subcommittee on the importance of assessing the costs and benefits of regulatory reforms, and if incorporation by reference may be allowed for prior testimony as proposed for BDC filings, then I ask for such treatment of that testimony.

I have not mastered the literature on BDC leverage or conducted an empirical analysis of BDC portfolios, but my limited preparation for this hearing has revealed

significant potential problems with the proposal to double the BDC leverage limit. And the paucity of literature and empirical analysis on BDC leverage is the first problem that the Subcommittee should consider. We have recently experienced the effects of inadequately regulated risk-taking and the systemic threat that it may pose. Over the last 15 years, market declines have substantially undermined Americans' confidence in the markets. Allowing BDCs to double their leverage will necessarily significantly increase the risk that one or more BDCs will fail in the wake of significant market decline. Putting more BDCs in a position to become worthless as a result of a significant market drop may throw fuel on that fire.

As discussed further below, BDCs present a number of problems that Congress should consider before permitting BDCs to double their leverage. One problem is that we lack an adequate method of estimating BDC leverage and its effect. One industry measure suggests that effective BDC leverage is actually many multiples of the ostensible 1:1 limit. Needless to say, this means that BCDs' current risk disclosure may be grossly inadequate, and their estimates of their portfolio values' sensitive to market declines grossly understated. Additionally, it is not clear that current law allows BDCs to use the full leverage that the 1:1 ratio appears to permit. Congress should consider the reasons that BDCs typically keep a substantial buffer in place that keeps their regulatory leverage well below what is supposedly allowed. Other concerns are that many BDCs invest substantial assets in investments that are not consistent with their mandate and they charge extremely high fees. Finally, if Congress wishes to increase BDC investments in small- to mid-sized firms, it should consider substantially reducing the 30 percent of assets that BDCs may invest in other companies. It is not clear that the 30 percent basket serves any purpose in modern financial markets.

As for a prior proposal to allow BDCs to invest half of their assets in financial services firms that are not eligible portfolio companies, I note the irony that while Congress seeks to make more capital available to small- and mid-sized companies, this proposal would make less capital available to such companies. The financial services firm proposal contradicts the very raison d'etre for BDCs, and it does so by diverting capital to firms that often provide services very similar or identical to the services provided by BDCs. If Congress believes that a social benefit that would be served by a

special purpose entity that invests half of its assets in financial services firms and half of its assets in small- and mid-sized companies, then it should create such an entity rather than destroy the already diluted identity that BDCs have spent almost 4 decades cultivating. It should also keep in mind that financial services firms do not create wealth by allocating capital, they only secondarily facilitate capital formation as intermediaries.

I. Doubling the BDC Leverage Limit

The bills would allow BDCs to increase their leverage ratio from 1:1 to 2:1. This would, as intended, make more capital available for BDCs to invest in the short-term. However, I am not aware of any reasoned basis for changing a decades-old standard, and there are many reasons why allowing increased leverage would be imprudent. Increased leverage is likely to have adverse long-term effects on the industry as a result of increased incidence of BDCs' incurring outsized losses or failing. It will pose significant risks for shareholders and abrogate the terms under which they made their investments. Current risk levels are poorly disclosed, and the leverage ratio itself is a crude measure that fails to reflect the reality of BDC leverage and the complexity of modern finance.

As discussed below, I have significant concerns regarding the proposal to allow BDCs to double their leverage. My concerns, due to the limited time available to prepare this testimony, are not, in all cases, fully formed, but they reflect genuine problems in the BDC industry that should be a much higher priority for Congress than granting BDCs more freedom to take greater risk.

(a) High BDC Fees

One concern is that BDCs are characterized by extremely high fees. The BDC registration statements that I reviewed show expense ratios consistently above 5.00 percent and, in some instances, significantly higher. For example, the manager of the largest BDC charges a management fee, income incentive fee, capital appreciation fee, and administrative fee.[1] The BDC's fee table that appears below[2] shows that total

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[1] Sample BDC Prospectus at 19 ("We [BDC A] may invest, to the extent permitted by law, in the equity securities of investment funds that are operating pursuant to

expenses, excluding interest on borrowings, are almost 6.5 percent of net assets:

Stockholder transaction expenses (as a percentage of offering price):		
Sales load	—	(1)
Offering expenses	—	(2)
Dividend reinvestment plan expenses	Up to $15 Transaction Fee	(3)
Total stockholder transaction expenses paid	—	(4)
Annual expenses (as a percentage of consolidated net assets attributable to common stock)(5):		
Base management fees	2.64%	(6)
Income based fees and capital gains incentive fees	1.71%	(7)
Interest payments on borrowed funds	3.19%	(8)
Other expenses	1.49%	(9)
Acquired fund fees and expenses	0.61%	(10)
Total annual expenses	9.64%	(11)

This table does not show certain expenses. For example, it does not include

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certain exceptions to the Investment Company Act and in advisers to similar investment funds and, to the extent we so invest, will bear our ratable share of any such company's expenses, including management and performance fees. We will also remain obligated to pay the base management fee, income based fee and capital gains incentive fee to our investment adviser with respect to the assets invested in the securities and instruments of such companies. With respect to each of these investments, each of our common stockholders will bear his or her share of the base management fee, income based fee and capital gains incentive fee due to our investment adviser as well as indirectly bearing the management and performance fees and other expenses of any such investment funds or advisers”). I would be happy to provide specific citations for this and other filings cited below to interested members.

[2] *Id.* at 16.

[3] These data assume that underwriters do not purchase any of their overallotment.

[4] The 0.61 percent ascribed to acquired funds represents those fees spread across the BDC’s total net assets, i.e., over assets that are not invested in the acquired funds. The actual fees charged on the part of the BDC’s net assets invested in the acquired funds would be up to 2.5 percent of assets and 25 percent of profits. *Id.* at 19 (“Certain of these Acquired Funds are subject to management fees, which generally range from 1% to 2.5% of total net assets, or incentive fees, which generally range between 15% and 25% of net profits.”). At the end of 2016, the BDC had $2.236 billion invested in “Investment Funds and Vehicles,” which represented 43.05 percent of its net assets at that time. This category comprised 21.2 and 25.2 percent

[5] *Id.* at 16.

underwriters fee that was paid in the offering made via this prospectus (0.70 percent of the $750 million offering, or about 0.07 percent of net assets). Nor does it show the commission that would be paid on a purchase of common shares or the associated offering expenses (4.43 percent and 0.21 percent, respectively, in the BDC's 2014 $235 million common stock offering, or about 0.16 percent of current net assets).[3]

The table also shows that the manager collects management fees on assets that *someone else is managing*. For this BDC, this double dipping amounts to 0.61 percent of the BDC's total net assets[4] – this fee would alone match the entire expense ratio for a reasonably priced mutual fund. The funds in which the manager invests the BDC's assets charge management fees ranging from 1.00 to 2.50 percent and performance fees ranging from 15 to 25 percent of net profits.[5] After those fees are paid, the BDC's manager collects those fees again.[6] Adding insult to injury, the manager may even collect fees on

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[5] *Id.*

[6] *Id.* ("We [the BDC] may invest, to the extent permitted by law, in the equity securities of investment funds . . . and, to the extent we so invest, will bear our ratable share of any such company's expenses, including management and performance fees. ***We will also remain obligated to pay the base management fee, income based fee and capital gains incentive fee to our investment adviser with respect to the assets invested in the securities and instruments of such companies.***" (emphasis added)).

income *that the BDC never receives*.[7]

While it may be more expensive to manage a BDC portfolio than other portfolios, this does not explain BDC expense ratios. There are bank loan funds and mutual funds that invest in very small companies that have expense ratios that are a fraction of BDC expense ratios. There are CEFs that have portfolios that appear to be quite similar to a typical BDC portfolio that have much smaller expense ratios. In some cases, BDC sponsors offer a similar CEF but charge substantially less to their CEF than they charge to their BDC.

In some cases, BDC expenses are significantly increased by fees paid to other investment vehicles. It is not clear how allowing BDCs to invest in other investment vehicles fulfills their purpose. For example, as noted above, the BDC that incurs 0.61 percent of net assets in fees on funds in which it invests appears to have approximately one-quarter of its assets invested in underlying investment vehicles. Some of these underlying investment vehicles are affiliated with the BDC manager. It appears that the BDC manager may itself be collecting fees in connection with the management of the underlying fund, thereby exacerbating what already constitutes substantial double dipping.

When a BDC makes a public offering, the fees can easily exceed 10% of the amount invested. For example, a BDC recently conducted an initial public offering that included a 4.00 percent commission, a 1.00 percent maximum contingent deferred sales charge, 1.00 percent in offering expenses, an annual 1.33 percent trailing commission,[8] a

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[7] *Id.* at 36 ("The income based fees payable by us [the BDC] to our investment adviser that relate to our pre-incentive fee net investment income is computed and paid on income that may include interest that is accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of such fee will become uncollectible. ***Our investment adviser is not under any obligation to reimburse us for any part of the income based fees it received that were based on accrued interest that we never actually receive.***" (emphasis added)).

[8] The BDC represented that the distribution fee would comply with Rule 12b-1 under the Investment Company Act, but such compliance is not required (and for

2.75 percent management fee, a 0.37 percent incentive fee, and a 0.85 percent fee representing other expenses. The estimated shareholder expenses for a one year investment were $109 of every $1,000 invested (10.9%) and, if the shares were sold after one year, $115 of every $1,000 invested (11.5%). And this fund was not investing in equities, where it is conceivable (albeit highly unlikely) that investment returns could make up for such large first-year expenses, but in debt, where making up for expenses, if ever, would take many years.

(b) Outdated Leverage Measure and Undisclosed Leverage Ratio

A second concern is that the 1:1 leverage ratio is woefully outdated and potentially misleading. When Congress adopted the CEF 1:1 leverage for BDCs, it did so at a time when understanding the capital structure of a company did not require a finance PhD. Almost 40 years later, complex capital structures may have rendered the 1:1 leverage limit meaningless for both BDCs and their portfolio companies. While BDCs purport to adhere to this limit, their actual leverage ratios not only may be substantially higher, but *many multiples* higher that 1:1.

Industry professionals have recognized the misleading nature of the BDC 1:1 leverage limit. In the words of banking analysts:

> In our view, the raw leverage measure (debt/equity) doesn't tell the whole story as the loans that BDCs hold have various degrees of implicit leverage.[9]

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mutual funds, a 12b-1 fee cannot exceed 1.00 percent). *See generally LPL to Limit Fees on Non-Traded REITs and BDCs,* thediwire.com (June 7, 2017) (limiting annual trailing commissions to 1 percent) *available at* https://thediwire.com/lpl-to-limit-fees-on-non-traded-reits-and-bdcs/.

[9] Wells Fargo 4Q17 BDC Scorecard at 14. The "implicit leverage" includes, for example, the leverage embedded in the capital structure of the BDC's portfolio companies. To illustrate, a $100 million 1st lien senior secured loan to a portfolio company presents far less risk than a $100 million subordinated unsecured loan, all other factors being equal. A BDC that routinely invests in the latter rather than the former will have a higher effective leverage ratio and be a riskier investment.

For example, a widely used industry publication found that some BDCs currently have effective leverage in excess of 5:1 – more than 9 times that of the least leveraged BDC considered.[10] As recently as 2015, the publication found BDCs with leverage in excessive of 7.5:1, with 12 of 25 BDCs evaluated boasting leverage in excessive of 4:1.[11] Effective leverage ratios ranging from 4:1 to 7.5:1 (if not higher) suggest that the 1:1 leverage limit is misleading and SEC disclosure requirements are grossly inadequate. It also means that BDC illustrative disclosure of the effect of a market decline on share value grossly understates the amount of potential losses. Before Congress considers allowing BDCs to increase their leverage, it should ensure that the BDCs' current level of risk is accurately estimated and adequately disclosed. Neither is currently the case.

(c) Effect of Doubling BDC Leverage

A third concern is that doubling the leverage allowed to BDCs will significantly increase the incidence of large losses and BDC failures. To illustrate, the table below shows how portfolio losses in a leveraged BDC would translate into much higher investor losses. This is the ineluctable effect of leverage, and the losses in the table would be substantially higher, of course, if the BDC were allowed to double its leverage.

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[10] Wells Fargo 4Q17 BDC Scorecard at 16 (showing, as of Sep. 11, 2017, effective leverage for 25 BDCs ranging from 0.56 to 5.20).

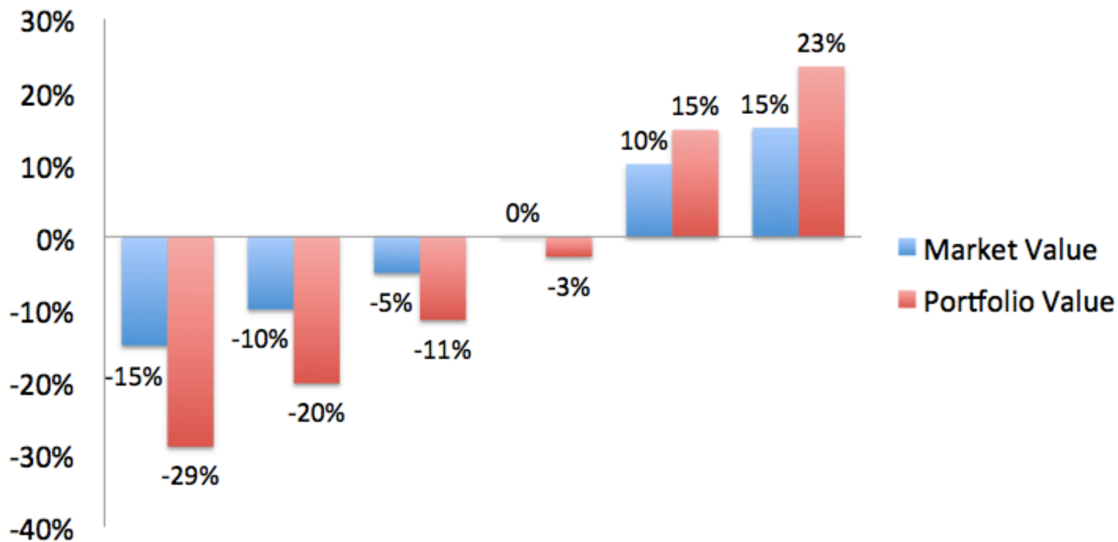
[11] Wells Fargo 4Q15 BDC Scorecard at 12. Two days ago, an equity research firm released a statement on the BDC that had the 7.5+:1 effective leverage ratio in 2015 that stated:

> Stock likely headed lower on severe credit weakness, NAV degradation, and dividend cut. Announced dividend reduction from $0.45 to $0.30/share appears warranted ***given credit induced earnings stress.*** The Board has begun to explore strategic alternatives including the sale of certain assets as well as the potential benefit of partnering with another organization.

Baird Equity Research (Nov. 2, 2017) (emphasis added).

Assumed Return on Portfolio (Net of Expenses)(1)	–15%	–10%	–5%	—%	5%	10%	15%
Corresponding Return to Common Stockholders(2)	–28.93%	–20.20%	–11.48%	–2.75%	5.97%	14.69%	23.42%

As noted, this table probably understates the losses that would be incurred if all sources of effective leverage were considered, such as the relative priority of loans to portfolio companies, and it does not include a truly significant market decline (e.g., -30 percent). In addition, the SEC should require that this table be presented in a bar chart, as is required for mutual funds, in order to make it intuitively understandable. The same table appearing above is shown as a bar chart below.



In fact, it is likely that raising the leverage ratio will *more* than double BDCs' risk level. The interest rate that a BDC pays on borrowing (or dividend preference on preferred shares) is based, in part, on the degree of risk presented by the BDC. When a BDC increases its riskiness by increasing its leverage, it will necessarily incur a higher cost of capital in the form of higher interest rates and/or dividend preference terms. For

example, banks, which typically make loans to BDCs subject to a 1:1 leverage limit,[12] will charge a higher interest rate to BDCs that may exceed the 1:1 limit. When a BDC pays more in interest, it must make riskier (subordinated) loans and/or loans to higher risk borrowers in order to maintain the same level of income and distributions to shareholders. While in good economic times shareholder returns will be even more inflated, in a downturn, BDCs are far more likely to fail. A decline in the value of a BDC's portfolio of only one-third may be sufficient to wipe out the fund.

(d) Investing in Non-Eligible Companies

A fourth concern is that some BDCs are not investing consistent with their statutory purpose. I have not had time to do an empirical analysis of BDC portfolios, but it appears that some BDCs have invested heavily in collateralized debt obligations ("CLOs").[13] These securities are not typically sold in the narrower capital markets in which small- and mid-size company debt is bought and sold. Rather, CLOs are funded by a large variety of investors and exhibit no lack of liquidity. The CLO market is not the market that BDCs were intended to serve. It also appears that the larger BDCs may be buying small pieces of debt tranches in which a wide variety of investors participate. Again, this is not the market that BDCs were intended to serve.

While the 30-percent basket that BDCs may fill with ineligible investments may have provided flexibility needed many decades ago, it is not clear why it is needed today. The most direct way to increase BDC lending to small- and mid-sized companies would be to reduce the 30-percent basket to 20 or 10 percent. The market for BDC shares is well-established, including the market perception that BDCs are a particular type of asset and that BDCs compete against other BDCs. I am not aware of any compelling evidence that BDCs still need the 30 percent basket, but this question needs study. Reducing this percentage may make the BDCs that are truly committed to this market more competitive

[12] Wells Fargo Equity Research at 3 (Nov. 2, 2015) ("many bank credit facilities to BDCs have 1:1 debt/equity covenants").
[13] Wells Fargo 4Q15 BDC Scorecard at 14 (BDC with a 2015 effective leverage ratio of "has a large portion of CLO equity, which in itself has higher amounts of leverage.").

with those BDCs that are not.

(e) Reasonable Shareholder Expectations

A fifth concern is that raising the leverage limit abrogates the deal that shareholders struck when they invested in a BDC. Investors bought their shares on the basis of a statutory leverage limit that the BDC could not alter. Now they will be confronted with having to sell their shares, possibly at a discount to net asset value that has grown larger in response to the BDC's increase in risk, thereby incurring an immediate tax, or stay in a fund that does not match their investment needs and experiences a significant decline in dividends. Non-traded BDC shareholder will not even have the opportunity to sell their shares.

The bills' leverage provision does not adequately protect shareholders' rights. For publicly-traded BDCs, *no shareholder approval* is required, so shareholders will have no say in whether a fundamental term of their investment is changed. Even with shareholder approval, as would be available for non-traded BDCs, dissenting shareholders will not even have the rights afforded to shareholders under corporate law. Although the BDC is required to offer to repurchase 25 percent of its shares for four quarters, there appears to be no requirement that shareholders be paid net asset value. Shareholders of BDCs that change such a fundamental investment policy should be allowed to vote on the change, and dissenting shareholders should have the immediate option of redeeming their shares at net asset value.

(b) Alternative Options

A sixth concern is that there may be a more appropriate way to allow BDCs to increase their leverage. It appears to be common practice for BDCs to keep a significant buffer between their regulatory leverage ratio and the 1:1 limit. This does not appear to reflect the fear that the BDC will violate the limit not by over-borrowing, but by experiencing a decline in asset values that causes its ratio to exceed 1:1. The leverage limit appears to require only that the BDC refrain from additional borrowing until is it back under the limit. It appears that BDCs are not permitted to pay dividends when

above the 1:1 limit, which might explain the buffer. If this is the case, then it may be appropriate, in my view, to permit them to pay dividends when over the limit as long as the dividends are paid out of income. If a BDC is over the limit, the receipt and immediate distribution of income would not adversely affect the BDC's starting leverage position. It may also be that the term structure of BDC borrowing results in a need to rollover short-term debt, and the leverage limit would be temporarily violated pending the liquidation of the expiring loan. If so, that problem could be fixed by allowing a grace period, up to a higher leverage limit perhaps (e.g., 1.2:1) during which debt could be rolled over as long as the BDC's leverage was no higher after the rollover than it was before. If the problem is bank loan covenants, the Subcommittee should inquire as to why these covenants are not structured along the lines above.

In short, the nature of a leverage limit in many contexts – banking, insurance, money market funds, etc. – is such that compliance generally should be able to be achieved without having to maintain a large buffer. Otherwise, the leverage limit is not actually the limit. A 1:1 leverage limit becomes a de facto 0.7:1 limit. I recognize that this discussion may be missing the reason for the buffers, but my sense is that there should be a way to allow BDCs to use the full limit prescribed by Congress. This alone would free up additional capital for investment.

II. Offering Rules

In 2005, the SEC adopted rules that were generally designed to liberalize securities offerings by operating companies and not designed for investment companies. Investment companies are regulated under a separate set of rules that are specifically tailored to such entities. For this reason alone, allowing CEFs and BDCs to rely on rules designed for operating companies is generally not an appropriate approach to securities offering reform.

The 2005 reforms were generally designed to address the problem of company communications being restricted or prohibited when the company is "in registration." A company is generally deemed to be "in registration" if it is planning to issue securities. Under the Securities Act, a company is generally prohibited from making *any* offers of

securities, orally or in writing, unless a registration statement has been filed with the SEC. The term "offer" is interpreted broadly – so broadly, in fact, that the pre-registration period is known as the "quiet period." Oral offers are permitted after a registration statement has been filed, but written offers (confusingly called "prospectuses") continue to be subject to restrictions.

The 2005 reforms addressed limits on communications that might be deemed to be offers by creating safe harbors for certain communications. The safe harbors are designed for operating companies, not investment companies, and they are further divided between rules for initial offerings and rules for offerings by reporting (public) companies (and further for reporting companies by size). For example, Rule 169 allows non-reporting issuers to release factual (i.e., not forward-looking) information prior to filing a registration statement if they routinely release the same type of information in the same manner. Rule 168 allows reporting companies to release factual *and* forward-looking information prior to filing a registration statement if they routinely release the same type of information in the same manner. Rule 163 allows well-known seasoned issuers ("WKSIs") to make offers prior to filing if the offer qualifies as a "free writing prospectus" and includes a cautionary legend. Rule 163A allows companies to release any type of information more than 30 days prior to filing a registration statement provided that the communication does not refer to the securities offering and the company takes reasonable steps to prevent dissemination of the communication within 30 days of the offering.

Mutual funds, closed-end funds and BDCs (and certain other types of issuers) are subject to different offering rules that are designed to reflect the differences between operating companies and investment companies. This presents the most significant concern regarding the proposed offering reforms. Closed-end funds and BDCs would become subject to two separate offering regulatory regimes and, apparently, be allowed to pick and choose which would apply. More to the point, they would be able to evade requirements that are specifically designed for non-reporting issuers such as registered investment companies by opting for a set of rules that were not written with investment companies in mind.

As noted above, the proposed offering reforms are particularly inappropriate for CEFs. Unlike BDCs, CEFs are not reporting companies. They do not file the reports that operating companies file under the Exchange Act. They file reports and use registration statements that are designed to reflect their nature as investment pools. The ICI has suggested that quarterly reports filed by CEFs are similar to quarterly reports filed by operating companies.[14] I think the ICI protests too much. Let's consider this comparison. The quarterly report filed by CEFs, Form N-Q, is nothing more than a certified list of portfolio holdings. Operating companies file Form 10-Q, which requires a discussion of legal proceedings (Item 1), risk factors (Item 1A), unregistered sales of equity securities and use of proceeds (Item 2), defaults upon senior securities (Item 3), and any other item that would be required to be disclosed on Form 8-K, which in turn requires disclosure of Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant (Item 2.03), Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement (Item 2.04), Costs Associated with Exit or Disposal Activities (Item 2.05), Material Impairments (Item 2.06), Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing (Item 3.01), Unregistered Sales of Equity Securities (Item 3.02), Material Modification to Rights of Security Holders (Item 3.03), Changes in Registrant's Certifying Accountant (Item 4.01), Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review (Item 4.02), Changes in Control of Registrant (Item 5.01), Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers (Item 5.02), Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year (Item 5.03), Temporary Suspension of Trading Under Registrant's Employee Benefit Plans (Item 5.04), Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics (Item 5.05), Change in Shell Company Status. Submission of Matters to a Vote of Security Holders (Item 6.01); Shareholder Director Nominations, ABS Informational and Computational Material.

[14] *See* ICI Testimony at 3 ("Like most publicly traded operating companies, closed-end funds file annual and semi-annual reports as well as quarterly reports. Each of these reports includes certifications from the principal executive officer.").

Change of Servicer or Trustee (Item 6.02), Change in Credit Enhancement or Other External Support (Item 6.03), Failure to Make a Required Distribution (Item 6.04), Securities Act Updating Disclosure (Item 6.05), Static Pool (Item 6.06), Regulation FD Disclosure (Item 7.01). A CEF's Form N-Q and an operating company's Form 10-Q are both filed quarterly. Any similarity ends there.

The comparison is also made to the registration process for mutual funds and interval funds on the one hand, and CEFs on the other.[15] Both mutual funds interval offer their shares for redemption, and both redeem shares at their net asset value. These entail registration and transactional burdens that CEFs do not approach. The idea that the registration burdens of mutual funds and interval funds is somehow lighter than it is for CEFs is ludicrous. Closed-end funds have been unsuccessful *despite* the significantly lower regulatory costs that they incur relative to other open-end investment vehicles. The CEF structure is simply not a structure that shareholders prefer; lipstick-on-a-pig offering reforms will do nothing to change that fact.

Closed-end funds are exempt from certain requirements that apply to reporting companies and would continue to be exempt under the proposed reforms. Unlike BDCs, CEFs register under the Investment Company, where Congress placed a set of requirements regarding the issuance of shares by mutual funds, closed-end funds and unit investment trusts that it designed for those types of issuers. The only logical arena within which to amend CEF offering rules is within the existing framework under which they are regulated. I am not aware of a similar package of proposals to that framework having been presented, the preference apparently being for the more lax environment that cherry-picked operating company rules offer. The application of operating company offering rules to CEFs seems to reflect a last-minute attempt to piggy back on changes being proposed for BDCs, which are fundamentally different in their regulation and purpose.

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[15] *Id.* at note 7 (noting eligibility of mutual funds and interval funds for immediate effectiveness). This is not to say that nonmaterial CEF filings should not be made immediately effective. Rather, they should be regulated within the set of rules that were designed for registered investment companies.

Some appear to believe that CEFs are entitled to offering reform because they have not been very popular with investors. This reasoning is hard to follow. Closed-end funds do not, in and of themselves, represent a public good that Congress should seek to make more popular. The regulation of BDCs reflects a conscious decision by Congress to increase a particular type of investing, in part by loosening certain Investment Company Act provisions. Closed-end funds are nothing more than a legal structure used for the intermediation of investment dollars. It does not make sense to lower the leverage limit that applies to closed-end funds simply to make them more popular when they are less popular for good reason. Closed-end funds are poor cousins to mutual funds and, more recently, their upstart nephews, exchange-traded funds, because they often trade at large discounts to the net asset value, they charge high fees, and their managers are less accountable to the marketplace because their shares are not redeemable. Their unpopularity has nothing to do with offering restrictions and is not a rational basis for creating an artificial advantage for them relative to mutual funds, exchange-traded funds, separate accounts, collective investment trusts and hedge funds.

In contrast, there is merit in some of the concerns that appear to have prompted the proposal for wholesale application of operating company offering rules to BDCs. This largely reflects the fact that BDCs, unlike CEFs, are reporting companies, and Congress made them reporting companies as part of a regulatory structure that it designed to facilitate investment in small- and mid-sized companies. Their status as reporting companies already creates at least a regulatory congruence with operating company regulation that does not exist for registered investment companies such as CEFs. The same type of information, at the same time intervals, is made available under Exchange Act reporting by BDCs as for operating companies that rely on operating company offering rules. Furthermore, the SEC has permitted BDCs to engage in the same practices that the key proposals appear to be designed to codify. And BDCs, unlike CEFs, are investment vehicles that serve a specific policy goal.

Along this reasoning, in my view BDCs should be afforded three benefits that properly reflect their reporting company status. First, they should be able to incorporate documents by reference. As noted, as reporting companies BDCs are subject to the kind

of continuous reporting that applies to operating companies, which are already permitted to incorporate by reference. Second, BDC registration statements that contain no material changes should become automatically effective upon filing[16] (I would reconsider this position if the SEC demonstrated that its review during delayed effectiveness has uncovered abuses relating to nonmaterial changes). Third, BDCs should be allowed full use of Rule 415's shelf registration provisions, although not under the ill-fitting guise of a Form N-2 Registration statement.[17] As the SEC has previously allowed, they should be subject to the same standards that apply, for example, to eligible Form S-3 filers.

In each case, however, it is not appropriate for Congress to specify the administrative law means by which the practical goals described above are achieved. Rather, Congress should simply instruct the SEC to adopt and/or amend rules as needed to accomplish these goals. Granted, the SEC's rulemaking paralysis may necessitate tying this instruction to a deadline after which the new standard becomes self-executing. But I am confident that allowing the SEC to determine how to navigate the most efficient way to accomplish these goals will result in rules that work better than legislated reforms for the industry and shareholders alike.

III. Proposed 50 Percent Limit for BDC Investments in Financial Firms

Prior versions of the bills would have permitted BDCs to invest up to 50 percent (or more) of their assets in financial firms that are not eligible investments. As this

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[16] The SEC has essentially permitted automatic effectiveness under certain no-action letters. *See* Nuveen Virginia Premium Income Municipal Fund (Oct. 6, 2006); Pilgrim American Prime Rate Trust (May 1, 1998).

[17] The Offering Rules Provisions create the impression that CEFs and BDCs are not currently allowed to conduct shelf offerings under Rule 415. In fact, CEFs and BDCs *routinely* conduct shelf registrations under Rule 415. For example, as recently as 2014, almost every BDC (79 out of 88) conducted at least one shelf offering under the rule. There has been no practical impediment to BDCs' conducting shelf offerings. For over two decades, CEFs and BDCs have relied on SEC no-action letters that permit them to conduct shelf offerings under Rule 415. The actual effect of the proposed shelf offering reforms would be to allow CEFs and BDCs to circumvent the long-established, carefully considered conditions under which the SEC has already allowed shelf offerings by these funds.

proposal may resurface, I am compelled to wonder why Congress would choose to make BDC less likely to serve their legislative purpose and more likely to lose the interest of shareholders. The reason for reduced regulation of BDCs is to make additional capital available to small- and mid-sized operating businesses. Allowing BDCs to increase their investments in financial firms would do the opposite. Every dollar that a BDC invested in a financial firm is a dollar that would be denied to the intended beneficiaries of BDCs' regulatory regime.

One BDC witness has illustrated precisely this point. He stated that, due to the existing 30% limit on investments in financial firms, "a BDC investing in a growing leasing company might have to curtail useful lending because of a limit that in context feels quite arbitrary." In other words, the BDC would not be allowed to divert more assets to a financial business that was doing what the BDC is supposed to do: make capital available to small- and mid-sized businesses.[18]

Permitting BDCs to invest 50% of their assets in financial services firms may destroy BDCs as a unique asset. Imagine a period in which financial firms perform well, while small- and mid-sized firms perform poorly. The market will view BDCs that hold a large percentage of financial stocks as better-performing "BDCs," while the rest are viewed, unfairly, as poorly-performing "BDCs." In fact, their relative performance would have little to do with their identity as BDCs. That term will have essentially lost

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[18] For example, the largest BDC has an $88.4 million investment (representing 1.7% of the fund's assets) in 10th Street LLC. *See* Sample BDC Prospectus at F-25. The webpage for 10th Street LLC describes it as having been founded "with the goal of providing capital to companies in the lower middle market." *At* http://www.tenthstreet.com/ (last visited Oct. 29, 2017). *See also id.* ("For over a decade, Tenth Street has been giving transaction support to equity sponsors by providing mezzanine debt and equity co-investments. Now investing out of a seventh fund, Tenth Street has raised almost $400 million in committed capital and provided it to growing companies in the lower middle market."). The website for another of the BDC's investments -- Imperial Capital Private Opportunities -- describes itself as "a Toronto-based private equity fund manager that focuses on investment opportunities in healthcare, business services, and consumer products in the Canadian and American mid-market." *At* http://imperialcap.com/ (last visited Oct. 29, 2017).

any real significance. The effect will be to strip all meaning from the concept of the BDC election – a concept that is likely already being substantially eroded under the current 30 percent limit. If BDCs are not held to their purpose, there is no reason to have BDCs.

IV. Money Market Fund Reforms

I testified before this Subcommittee on money market fund reforms before they were adopted by the SEC. My views have not changed, but circumstances have. Dozens of money market funds have closed, hundreds of billions of dollars of credit that had been extended to businesses have been diverted to the U.S. government, and institutional investors looking to find a short-term home for their cash have been forced to reevaluate their longstanding preference for money market funds.

Notwithstanding such adverse effects, I cannot support the current proposal absent an empirical analysis of the after-effects of the money market fund rulemaking. Just as the original rules were adopted with an inadequate understanding of their effect, Congress should not rush turn back the clock without know the effect of doing so. The SEC intends to analyze the effect of the reforms, and I believe, in light of what I viewed as an errant perspective the first time around, that the agency might benefit from direct instructions from Congress as to the relevant questions that it should answer.[19] In short, my position is similar to Chairman Clayton's, who has opined that "it's too early to say we're wrong." I recognize that it's too early to say I was right.

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[19] This should include an analysis of the current status of the SEC's longstanding, extra-judicial practice of granting ad hoc, last minute, oral no-action relief to MMFs that were at risk of imminent failure. I refer the Subcommittee to the comment letter I submitted to the SEC eight months prior to the collapse of the Reserve Fund that warned that the developing credit crisis warranted immediate action to protect MMFs, including specifically a re-evaluation of the staff's ill-advised no-action practices. Indeed, the SEC's excessive reliance on no-action positions, and concomitant failure to codify their positions, is one reason that the pending bills have been proposed. SEC rulemaking paralysis continues to be a significant problem at the agency, as I have also discussed in prior testimony before the Subcommittee.

I am also concerned about the bill's restrictions on banking regulators' ability to take emergency action in the event of another severe liquidity event. While we might believe today that such action is inappropriate, we might take a different view upon the onset of another financial crisis. By analogy, the Delaware courts have held that it is not consistent with a corporate director's fiduciary duty to adopt a poison pill to frustrate a hostile takeover that no future board member can change. Such poison pills, appropriately named "dead hand" provisions, are impermissible because they prevent future board members from taking steps that they deem to be in the best interests of shareholders. It is a dangerous practice to remove emergency powers from the set of tools we have to mitigate financial crises.

I understand that tying banking regulators' to the mast, so to speak, may signal to investors that MMFs will not be bailed out in the future. However, I doubt very much that this will influence investors' behavior or attitudes. And this approach may backfire in the event that banking regulators are unable to prevent a full-blown run on MMFs, which may lead to the systemic meltdown we recently so narrowly avoided. Treasury bailouts are not all bad, or even "bailouts." It is worth recalling that the U.S. Treasury pocketed more than $1 billion insurance premiums paid by MMF shareholders without paying a single penny in claims.

There are structural checks that Congress could use to ensure proper oversight of banking regulators' exercise of emergency powers without making those powers practicably unavailable. A common approach is to make the exercise of power contingent on certain findings being made, which could be required of the heads of multiple agencies (this is the approach that Congress used after the 1980s banking crisis to impose tighter discipline on FDIC decisions on whether to allow weak banks to remain in business). Banking regulators could be required to submit proposed actions to a process that allowed Congress – perhaps initially through a designated committee, which then could pass a recommendation for further action by the full body – to intercede without preventing the prompt action that is sometimes needed to right the ship before it sinks. It is almost always more workable to authorize emergency action in advance while

providing for a shut-off valve, than to prohibit emergency action that must be legislatively restored to be used in an emergency.