May 20, 2021

Ms. Martha Legg Miller
Director, Office of the Advocate for Small Business Capital Formation
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: 40th Annual SEC Government-Business Forum on Small Business Capital Formation

Dear Ms. Miller:

The Small Business Investor Alliance (SBIA) appreciates this opportunity to provide recommendations for the 40th Annual Securities and Exchange Commission (SEC) Government-Business Forum on Small Business Capital Formation (Forum). We appreciate the ongoing work of the SEC to help meet the capital needs of America's small and middle market businesses and to provide investors with greater opportunities to participate in the growth of the next generation of American businesses.

The SBIA is a national association that develops, supports, and advocates on behalf of policies that benefit investment funds that finance small and mid-size domestic businesses in the middle market and lower middle market, as well as the investors that provide capital to these funds. Our membership includes Small Business Investment Companies (SBICs), Rural Business Investment Companies (RBICs), Business Development Companies (BDCs), conventional private equity funds, private debt funds, and other funds investing in American private small businesses.

SBIA members have a unique and important perspective on the challenges currently facing small and mid-size businesses and the need for further action from the SEC and Congress to modernize regulations in a manner that stimulates our economy.

The SBIA recently provided the below recommendations and supporting rationale to Congress and have also submitted them to the Forum's online portal:

1. **In order to foster investment in BDCs and provide accurate disclosures for investors, the SEC should move the acquired fund fees and expenses ("AFFE") line item out of a fund's prospectus fee table to a footnote or narrative discussion accompanying the fee table. Alternatively, BDCs should be exempted from the definition of an "acquired fund" under Forms N-1A, N-2, N-3, N-4, and N-6.**

2. **BDCs and their affiliated funds should be permitted to engage in certain "co-investment" transactions similar to the terms outlined by the SEC's temporary relief order of April 2020.**

3. **Preferred stock issued by BDCs should be counted as equity for purposes of asset coverage requirements under the Investment Company Act.**

4. **Congress should build upon the SEC's recently finalized accredited investor rule by passing the Fair Opportunities for Investment Professionals Act.**

5. **Congress should approve the Helping Angels Lead our Startups (HALOS) Act, which would provide a permanent fix for a regulatory oversight and promote communication between small and startup businesses and potential investors.**

These recommendations are discussed in greater detail below.

Recommendations

In order to foster investment in BDCs and provide more accurate disclosure for investors, the SEC should move the acquired fund fees and expenses ("AFFE") line item out of a fund's prospectus fee table to a footnote or narrative discussion accompanying the fee table. Alternatively, BDCs should be exempted from the definition of an "acquired fund" under Forms N-1A, N-2, N-3, N-4, and N-6.

Congress established the legal framework for BDCs in 1980 as part of the Small Business Investment Incentive Act ("SBIAA"). BDCs are regulated by the Securities and Exchange Commission (SEC) and are a specialized type of closed-end fund that invest in, and provide managerial assistance to, small and middle market U.S. businesses.

BDCs are required by statute to invest 70% of their portfolio assets in cash, securities issued by financially troubled businesses, or certain securities issued by "eligible portfolio companies," which generally consist of non-public U.S. businesses. Unlike other types of investment funds which may take a more passive role with portfolio companies, BDCs must make available "significant managerial assistance" to eligible portfolio companies. This assistance is critical for many small and middle market businesses, particularly during adverse economic conditions or when they are facing significant market competition.

BDCs also provide several important advantages for investors, including a meaningful and consistent source of income and the ability of retail investors to participate in the growth of private companies in the middle market. BDCs are highly regulated, transparent vehicles that are subject to robust oversight by the SEC.

In 2006, the SEC adopted the AFFE rule, which requires funds that invest in other funds to disclose as an additional line item in its prospects fee table the *pro rata* share of the total annual operating expenses paid by acquiring funds. This expense is then added to the acquiring fund's *actual* operating expense and increases the acquiring fund's bottom line expense ratio that is disclosed in the fee table.

Because of the unique business model of BDCs and the fact that BDCs often provide managerial assistance or services that other funds do not, a BDC's expense ratio can be higher than that of a typical mutual fund or closed-end fund. However, the AFFE line-item component of a fund's expense ratio is not a true fund operating expense. Instead, the AFFE line-item is added to expenses that are deducted

from the fund's net investment income. In other words, the AFFE disclosure as it applies to BDCs effectively "double counts" the true cost of investing in BDCs.

The AFFE rule has led a number of index providers to drop BDCs from their indices due to the perceived cost of BDC investment. This caused a substantial decline in BDC investment by index funds, notwithstanding the fact that some fund complexes have acknowledged how the AFFE rule misrepresents the actual cost of investing in BDCs.[1]

In August 2020, the SEC proposed a rulemaking that included provisions to address the AFFE issue.[2] The SEC's proposal would permit acquiring funds with less than 10% of their assets in acquired funds to move AFFE disclosure to a footnote to the fee table. However, when this proposal was adopted, SEC Commissioner Peirce noted that the complexities that such an arbitrary threshold would create and asked whether *all* AFFE disclosure should be in the footnotes.[3]

The SBIA believes that it should and submitted a comment letter to SEC explaining why allowing all AFFE to be disclosed in the footnotes would result in more accurate information presented in the fee table.[4] The SBIA also has had extensive discussions regarding this topic with fund managers, index providers, and our member BDCs. We believe that allowing for footnote disclosure will ultimately result in greater institutional investment in BDCs which, in turn, means that BDCs will be able to deploy more capital to small and mid-size businesses across the country.

An alternative approach would be for Congress or the SEC to exempt BDCs from the definition of an "acquired fund" under Forms N-1A, N-2, N-3, N-4, and N-6. The SEC staff has previously acknowledged that the definition of an "acquired fund" encompasses certain investment vehicles that were never intended to be captured by the original AFFE rule. In 2017, SEC staff issued FAQ's that excluded "structure financed vehicles, collateralized debt obligations, or other entities not traditionally considered pooled investment vehicles" from the definition of "acquired fund."[5] Because of the high degree of active management involved in running a BDC portfolio, we believe BDCs should also be considered a non-traditional pooled investment vehicle. Legislation to exempt BDCs from the AFFE requirements was introduced in the House of Representatives by Reps. Brad Sherman and Steve Stivers in June 2020.[6]

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[1] For example, the prospectus for the Hartford fund complex states: "The Fund will indirectly bear a pro rata share of fees and expenses incurred by any investment companies in which the Fund is invested … BDC expenses are similar to the expenses paid by any operating company held by the Fund. They are not direct costs paid by Fund shareholders and are not used to calculate the Fund's net asset value. They have no impact on the costs associated with Fund operations."
https://www.sec.gov/Archives/edgar/data/1053425/000110465920076127/tm2022842d1_485bpos

[2] Tailored Shareholder Reports, Treatment of Annual Prospectus Updates for Existing Investors, and Improved Fee and Risk Disclosure for Mutual Funds and Exchange-Traded Funds; Fee Information in Investment Company Advertisements. (85 FR 70716) August 5, 2020.

[3] Statement on Tailored Shareholder Reports (Commissioner Hester Peirce) August 5, 2020.

[4] https://www.sec.gov/comments/s7-09-20/s70920-8096108-226181.pdf

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

[6] H.R. 7375, Access to Small Business Investor Capital Act. Available at H.R.7375 - 116th Congress (2019-2020): Access to Small Business Investor Capital Act | Congress.gov | Library of Congress

BDCs and their affiliated funds should be permitted to engage in certain "co-investment" transactions, similar to the terms outlined by the SEC's temporary relief order of April 2020.[7]

It has become common practice for BDC's and their affiliated funds to enter into "co-investment" transactions when the BDC is externally managed on a platform with private funds that follow a similar investment strategy. While this can greatly benefit portfolio companies and afford BDCs another avenue to commit capital, they have historically been regulated by a patchwork of SEC staff no-action letters and exemptive orders. This disjointed approach to regulation has often left BDCs and their investors uncertain as to when and under what circumstances they can enter into co-investment transactions.

In response to the COVID-19 pandemic and recognizing the need to get capital to small and mid-size businesses, the SEC issued temporary exemptive relief in April 2020 that allowed BDCs currently operating under an exemptive order to engage in follow-on transactions. This order expired at the end of 2020 and the SEC has announced it will take a "no-action" approach to enforcement through March 31, 2021 for BDCs that avail themselves of the relief outlined in the order.

The SBIA provided the following real-life examples to the SEC of BDCs that were able to engage in co-investment transactions due to the exemptive relief provided by the SEC:

- Case #1: In 2018, an Advisor made an $87 million 2nd lien term loan investment across its BDC and a number of private funds pursuant to its co-investment exemptive order. In the aggregate, the Advisor's funds held the entire 2nd lien term loan. In October 2020, the company was looking for an additional $35 million to fund its M&A activities. The private funds that held the 2nd lien were either out of their investment period or had very limited liquidity. The BDC's investment in the 2nd lien was already $21,250,000. The BDC participated in the follow-on with other new private funds but capped its aggregate position at $27.5 million as its maximum desired position given that this was 2nd lien. Absent the temporary relief, the BDC and other private funds that held the 2nd lien would not have been able to provide the full $35 million in incremental financing and the company might have refinanced them out altogether in order to raise the capital.

- Case #2: In 2017, 2019 and 2020, an Advisor had made aggregate investments of $52.5 million across its BDC and one private fund pursuant to its co-investment exemptive order. In November 2020, the company was looking for $7.5 million in incremental financing to support its M&A activities. The private fund that held the investment was out of its investment period. The BDC's investment in the issuer was already $43 million and it did not wish to add to that position. The Advisor was able to bring in new private funds to provide the incremental financing. Absent the temporary relief, the BDC may have been forced to decide between upsizing beyond its comfort level or being refinanced out altogether.

Importantly, no investor protection or market risk concerns have been raised due to the exemptive relief order being in place, and there is no compelling argument regarding investor protection or other concerns that should prevent this relief from becoming permanent. We believe that if the SEC fails to do

[7] Order under Sections 6(c), 17(d), 38(a) and 57(i) of the Investment Company Act of 1940 and Rule 17d-1 thereunder granting exemptions from specified provisions of the Investment Company Act and certain rules thereunder (April 8, 2020).

so on its own, Congress should direct the Commission to undertake a rulemaking that codifies the relief outlined in the April order.

Preferred stock issued by BDCs should be counted as equity for purposes of asset coverage requirements under the Investment Company Act.

Additionally, Congress could improve the long-term outlook for BDC portfolio companies by allowing the preferred stock issued by BDCs to institutional investors to be treated as equity for purposes of the asset coverage and other requirements under the Investment Company Act. This would be another way to assist BDCs in deploying capital and working with their portfolio companies.

Congress should build upon the SEC's recently finalized accredited investor rule by passing the Fair Opportunities for Investment Professionals Act (H.R. 4762 from the 116th Congress).[8]

In August 2020, the SEC took the first step towards revising the longstanding definition of an "accredited investor" by expanding eligibility criteria beyond income and net worth thresholds.[9] The final rule allows the Commission to designate by order individuals who hold certain securities licenses (e.g. FINRA series 7, 65, and 82) or those who have certain professional certifications (e.g. MBA or Chartered Financial Analyst) as accredited. The SEC also expanded the criteria to include "knowledgeable employees" of a private fund and RBICs, amongst other entities.

While these reforms were a step in the right direction, we believe that Congress can and should go further, particularly given the steady growth of private capital markets in recent years. Contrary to criticisms that opening the private markets to more households will weaken investor protections, allowing investors to have a mix of both private and public companies in their portfolios can actually *reduce* their long-term investment risk. Then-SEC Commissioner Mike Piwowar made this point in 2016 when he stated that "by holding a diversified portfolio of assets, investors reap the benefits of diversification…when adding higher-risk, higher-return securities to an existing portfolio, as long as the returns from the new securities are not perfectly positively correlated with the existing portfolio, investors can reap higher portfolio returns."[10] In other words, further expansion of the accredited investor definition is entirely consistent with the SEC's statutory mission to protect investors and facilitate capital formation.

The Fair Investment Opportunities for Professional Investors Act would allow individuals who are able to demonstrate financial sophistication to be deemed accredited, regardless of whether they hold a securities license or some type of professional certification. The SEC would be afforded the flexibility to determine how to qualify an investor, which could be done by allowing individuals who pass FINRA's "Securities Industry Essentials" exam to become accredited, or some other mechanism that the SEC deems appropriate.

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[8] Text available at: https://www.congress.gov/bill/116th-congress/house-bill/4762/text?q=%7B%22search%22%3A%5B%22fair+investment+opportunities%22%5D%7D&r=1&s=4

[9] Accredited Investor Definition (85 FR 64234) August 26, 2020.

[10] Remarks at the Meeting of the SEC Advisory Committee on Small and Emerging Companies. Commissioner Michael S. Piwowar (May 18, 2016).

Congress should approve the Helping Angels Lead our Startups (HALOS) Act (S. 1063, H.R. 1909 from the 116th Congress)[11], which would provide a permanent fix for a regulatory oversight and promote communication between small and startup businesses and potential investors.

When the SEC implemented the general solicitation provisions under Title II of the 2012 Jumpstart our Business Startups (JOBS) Act, it regrettably put in place certain restrictions against communication between startup businesses and potential investors. The HALOS Act would clarify that that startups and angel investors are permitted to communicate at "demo days" or other similar events, provided that no specific offering of securities is made.

The HALOS Act has garnered strong bipartisan support in both the House and Senate for several years, and its provisions would do nothing to undermine important investor protections. This bill was also included as part of the JOBS and Investor Confidence Act, which passed the House of Representatives by a vote of 406-4 in July 2018. While the SEC has recently finalized rules that address the issue, a permanent statutory fix is the only way to ensure these provisions of the JOBS Act remain in place.

Conclusion

The SBIA thanks the SEC for holding the Forum and considering proposals to facilitate capital formation and help small and middle market businesses access the financing they need to grow and hire. We look forward to working with the Commission regarding these proposals and other issues.

Sincerely,

Tonnie Wybensinger
Executive Director, Government Relations

Cc: Chairman Gary Gensler
Cc: Commissioner Hester Peirce
Cc: Commissioner Allison Herren Lee
Cc: Commissioner Elad Roisman
Cc: Commissioner Caroline Crenshaw

[11] Text available at:https://www.congress.gov/bill/116th-congress/senate-bill/1063/text?q=%7B%22search%22%3A%5B%22helping+angels+lead%22%5D%7D&r=1&s=6