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Alternative Credit Council response to Crapo, Brown request for proposals to foster economic growth

The Alternative Credit Council (ACC)[1] is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 80 members that manage $300bn of private credit assets. The ACC is an affiliate of the Alternative Investment Management Association (AIMA) and is governed by its own board which ultimately reports to the AIMA Council.

ACC members provide an important source of funding to the economy. They provide finance to mid-market corporates, SME's, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

Alternative credit, private debt or direct lending funds have grown substantially in recent years and are becoming a key segment of the asset management industry. The ACC seeks to explain the value of private credit by highlighting the sector's wider economic and financial stability benefits

The ACC welcomes the opportunity to respond to this request for proposals to foster economic growth.

Modernising Business Development Companies

We believe that Business Development Companies (BDCs) play a significant and vital role ensuring that smaller American businesses are able to access the capital they need to invest, grow and support jobs. As vehicles specifically designed to facilitate investment into smaller firms BDCs have also played an increasingly important role since the financial crisis and the retrenchment of traditional lenders from serving these customers.

Whilst the rationale for BDCs – improving access to capital for small and medium size businesses whilst maintaining robust and responsible lending standards – remains more relevant than ever, some of the requirements on BDCs have become outdated and in need of modernisation.

BDCs are currently subject to extensive regulatory requirements and disclosure obligations imposed by the Investment Company Act of 1940. Publicly traded BDCs are also subject to additional

[1] https://www.aima.org/acc.html

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regulations under the Securities Act of 1933 and the Securities Exchange Act of 1934. These include, among other things, requirements to:

- Invest at least 70% of their assets in small and medium sized U.S. operating businesses that do not have ready access to the public markets;
- Comply with an asset coverage test which requires at least one dollar of equity for every dollar of debt; and
- Publish a quarterly summary of each investment held by a BDC and the fair value of such investment.

Although these requirements have contributed towards BDCs being seen by borrowers, regulators and investors as responsible lenders, they also create operational challenges which limit the capacity of BDCs to lend.

We believe that pragmatic reforms of the asset coverage test and BDC offering, filing and registration requirements will enable BDCs to increase their lending capacity without compromising their lending standards or their specific mandate to provide finance to small and medium sized American businesses.

1. Reform of the asset coverage test

Whilst the asset coverage test requires BDCs to maintain a minimum 1:1 debt to equity ratio, in practice most BDCs will maintain a lower average leverage ratio. BDCs are required to value their portfolio companies on a 'mark to market' basis and any negative changes in the broader loan market may reduce the fair market value of the BDC holdings, regardless of the actual performance of the BDCs portfolio companies. Any reduction in the fair market value of their holdings leads to an automatic increase in the BDCs debt to equity ratio. BDCs therefore use a lower debt to equity ratio than they are permitted to ensure that there is a buffer in the event of any unexpected or sudden drop in asset values. Whilst this is prudent behaviour from an operational perspective, it restricts the ability of BDCs to raise and invest capital which, in turn, limits a BDCs ability to invest in American businesses.

An additional consequence of this limitation is to hamstring a BDCs ability to achieve its targeted investment returns by preventing it from using leverage to improve investment returns on lower risk assets. Using leverage in this manner, i.e. to improve returns on lower risk assets, is recognised as an effective way of alleviating risk concentration within an investment portfolio. This is generally referred to as a risk parity approach and ensures that any expected risk contribution of the portfolio is spread more evenly across the various individual components that make up a typical diversified portfolio. This can be achieved through disproportionate allocations within the portfolio to lower risk asset classes and reducing the exposure to higher risk asset classes, however, for the portfolio to meet investment return expectation while maintaining a similar degree of risk, some leverage will need to be employed on the investments in the lower risk assets.

The current asset coverage test restricts BDCs from using this approach and makes it more challenging for them to achieve the dividend expectations of their shareholders and RIC distribution requirements. This manifests itself in BDCs being encouraged to invest in higher-yielding and

potentially riskier securities particularly in the non-qualifying assets that are not "eligible portfolio companies" which are permitted to make up to 30% of BDC investments. Non-qualifying assets can be non-US companies, CLOs and a whole range of investments outside of the core small and medium sized American businesses.

The ACC would respectfully suggest that increasing the BDC asset coverage test from 1:1 to 2:1 would improve a BDCs ability to raise capital and invest without creating undue risk or compromising the responsible lending practices of BDCs. It would also provide BDCs with more headroom to invest in lower yielding (and likely lower risk) assets than they currently enjoy which will support the construction of diversified portfolios. This could be achieved by amending Section 61(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–60(a)).

This moderate increase in the asset coverage test from 1:1 to 2:1 would equalise the BDC leverage ratio with the Small Business Investment Company Debenture program. We would also highlight how, under the EU Alternative Investment Fund Management Directive (AIFMD), Alternative Investment Funds (AIFs) are only considered to be employing leverage on a substantial basis if their leverage ratio exceeds 2:1 – such a ratio is therefore seen as a relatively safe and prudent by one of the most stringent asset management regulatory regimes. Furthermore, our proposed increase in the asset coverage test would also require BDCs to operate with significantly less leverage than found in the traditional lending sector.

BDCs use mark to market accounting practices and make regular material disclosures on their activities which means their activity is extremely transparent in relation to other lenders. We also believe that BDCs help to increase the resilience of the financial system as the activity they undertake does not involve maturity or liquidity transformation - the practice of making long-term loans on money that has been deposited by customers on a short-term basis.

We therefore do not believe this reform would lead to any significant increase in the risks to financial stability. On the contrary, strengthening BDCs ability to lend would encourage a diversity in funding sources and competition which will support effective markets.

Increasing the asset coverage ratio would represent an important change to the BDC from an investment perspective. The ACC would therefore also propose that proportionate safeguards, including a shareholder vote with a majority of independent board directors, should be introduced to agree any changes to a BDCs asset coverage ratio. Additionally, any changes should only be possible following a 12 month period after any vote has taken place. Shareholder interests will also be protected via BDC SEC disclosure requirements which require a BDC to state the level of leverage that it can use and the amount of leverage actually used. Shareholders will also be informed about the potential risks associated with leverage via the same disclosures.

2. Updating the offering, filing and registration requirements for BDCs

BDCs are currently unable to use the existing streamlined reporting and registration procedures that are available to other similar public companies - specifically those who also have a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934. As well as placing BDCs on an uneven playing field, this has practical implications for BDCs who are seeking to access the

capital markets as offering windows open and close very quickly making it much harder for BDCs to raise capital which they then deploy to small and medium sized American businesses.

The ACC would respectfully suggest that BDCs should have a right to use these streamlined reporting and registration procedures. This could be achieved by allowing BDCs to:

- be designated as "well known seasoned issuers" and to make use of an automatic shelf registration;
- access the safe harbours available to other operating companies;
- register on Form S-3 even if they are required to register on Form N-2; and
- rely on this "access equals delivery" rule and use forward incorporation by reference on Form N-2.

We believe that these reforms would significantly improve the offering, filing and registration requirements for BDCs and enable them to act more efficiently. This will enhance their ability to lend to American businesses and support economic growth. We have provided detailed suggestions on how these reforms could be introduced in the annex to this paper and would be happy to discuss these and any other aspects of this paper further.

Yours sincerely,

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Annex 1 - Updating the offering, filing and registration requirements for BDCs

We would respectfully propose the following legislative amendments to achieve the BDC reforms we have proposed:

- revise rule 405 under 12 the Securities Act of 1933 (17 C.F.R. 230.405) to remove the exclusion of BDC from the definition of a well-known seasoned issuer and add registration statements filed on Form N–2 to the definition of automatic shelf registration statement provided by that rule;
- revise rules 168 and 169 under the Securities Act of 1933 (17 C.F.R. 230.168 and 230.169) to remove the exclusion of a BDC from an issuer that can use the exemptions provided by those rules;
- revise rules 163 and 163A under the Securities Act of 1933 (17 C.F.R. 230.163 and 230.163A) to remove a BDC from the list of issuers that are in eligible to use the exemptions provided by those rules;
- revise rule 134 under the Securities Act of 1933 (17 C.F.R. 230.134) to remove the exclusion of a BDC from that rule;
- revise rules 138 and 139 under the Securities Act of 1933 (17 C.F.R. 230.138 and 230.139) to specifically include a BDC as an issuer to which those rules apply;
- revise rule 164 under the Securities Act of 1933 (17 C.F.R. 230.164) to remove a BDC from the list of issuers that are excluded from that rule;
- revise rule 433 under the Securities Act of 1933 (17 C.F.R. 230.433) to specifically include a BDC that is a well-known seasoned issuer as an issuer to which that rule applies;
- revise rule 415 under the Securities Act of 1933 (17 C.F.R. 230.415) (to state that the registration for securities provided by that rule includes securities registered by a BDC on Form N–2, and provide an exception for a BDC from the requirement that a Form N–2 registrant must furnish the undertakings required by item 34.4 of Form N–2;
- revise rule 497 under the Securities Act of 1933 (17 C.F.R. 230.497) to include a process for a BDC to file a form of prospectus that is parallel to the process for filing a form of prospectus under rule 424(b);
- revise rules 172 and 173 under the Securities Act of 1933 (17 C.F.R.230.172 and 230.173) to remove the exclusion of an offering of a BDC from those rules;
- revise rule 418 under the Securities Act of 1933 (17 C.F.R.230.418) to provide that a BDC that would otherwise meet the eligibility requirements of General Instruction I.A of Form S–3 shall be exempt from paragraph (a)(3) of that rule;
- revise rule 14a–101 under the Securities Exchange Act of 1934 (17 C.F.R. 240.14a–101) to provide that a BDC that would otherwise meet the requirements of General Instruction I.A of Form S–3 shall be deemed to meet the requirements of Form S–3 for purposes of Schedule 14A;
- revise rule 103 under Regulation FD (17 C.F.R. 243.103) to provide that paragraph (a) of that rule applies for purposes of Form N–2;

- revise Form N–2 to include an item or instruction that is similar to item 12 on Form S–3 to provide that a BDC that would otherwise meet the requirements of Form S–3 shall incorporate by reference its reports and documents filed under the Securities Exchange Act of 1934 into its registration statement filed on Form N–2; and
- revise Form N-2 to include an item or instruction that is similar to the instruction regarding automatic shelf offerings by well-known seasoned issuers on Form S–3 to provide that a BDC that is a well-known seasoned issuer may file automatic shelf offerings on Form N–2.