



BY ELECTRONIC TRANSMISSION

July 29, 2019

Vanessa Countryman
Acting Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: SEC File No. S7-05-19: SBIA Comments on Amendments to Regulation S-X

Dear Ms. Countryman:

The Small Business Investor Alliance (“**SBIA**”) appreciates the opportunity to comment on the Securities and Exchange Commission’s (“**SEC**”) proposed amendments to rules that require business development companies (“**BDCs**”) to include in their SEC filings certain financial information pertaining to their majority-owned and controlled portfolio companies.¹

The SBIA is the leading 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 nearly 50 funds electing BDC status under the Investment Company Act of 1940 (the “**1940 Act**”) and their external managers, as well as the investors that invest in these funds, including, but not limited to, banks, family offices and funds of funds.

At the outset, we would like to thank the SEC for taking into account many of the comments submitted by BDC industry counsel² on the SEC’s “Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant”³ in connection with formulating the rule proposals (the “**Proposed Rules**”) set forth in the Proposing Release. We believe that the suggested changes to the Proposed Rules described in this letter advance the SEC’s goals of (i) improving the financial disclosure about majority-owned and controlled portfolio companies of BDCs by ensuring that such information is included in the SEC filings of BDCs only when material to investors’ investment decisions and (ii) reducing the time, effort and expense associated with preparing such disclosure for BDCs and their portfolio companies.

¹ SEC, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, Rel. No. 33-10635; 34-85765; IC-33465 (May 3, 2019) (the “**Proposing Release**”).

² See Comment letter submitted by Sutherland Asbill & Brennan LLP dated November 30, 2015, *available at* <https://www.sec.gov/comments/s7-20-15/s72015-20.pdf> (the “**November 2015 Comment Letter**”).

³ SEC, *Request for Comment on the Effectiveness of Financial Disclosures About Entities Other Than the Registrant*, Release No. 33-9929 (September 25, 2015).

A. Background

In 2013, the staff of the SEC's Division of Investment Management (the "*Staff*") issued guidance setting forth its views regarding the applicability of Rules 3-09 and 4-08(g) of Regulation S-X⁴ to certain portfolio company holdings of BDCs.⁵ Although not explicitly discussed in the BDC Portfolio Company Guidance, the Staff has taken a similar position with respect to the applicability of Rule 10-01(b)(1) to the portfolio company holdings of BDCs. Prior to the issuance of the BDC Portfolio Company Guidance, it was generally thought that these rules did not apply to BDCs for the reasons discussed elsewhere herein.

Rules 3-09, 4-08(g) and 10-01(b)(1) reference or otherwise look to the significant tests in Rule 1-02(w) (*i.e.*, the investment test, asset test and income test) to determine whether additional financial disclosure with respect to one or more of a BDC's portfolio companies must be included in the BDC's SEC filings. Given that these rules are based on operating company accounting, and investment company accounting differs from operating company accounting in some respects, the Staff has provided informal guidance as to how these rules apply to BDCs.⁶ Based on this guidance, Rule 3-09 applies to majority-owned subsidiaries, and Rules 4-08(g) and 10-01(b)(1) apply to controlled portfolio companies. Under Section 2(a)(9) of the 1940 Act, a person who beneficially owns, either directly or through one or more controlled companies, more than 25% of the voting securities of a company is presumed to control such company.

Since 2013, it has become evident that the application of Rules 3-09, 4-08(g) and 10-01(b)(1) to BDCs oftentimes would require BDCs to include additional financial disclosure in their SEC filings for portfolio company investments that are *de minimis* or no longer held. As a result, many BDCs have sought and received informal Staff waivers from the requirements of these rules in various circumstances where additional disclosure was not necessary to reasonably inform investors. The November 2105 Comment Letter urged the SEC to formally codify some of these informal Staff positions, e.g., that the "aggregated" or "group" basis concepts in Rule 4-08(g) do not apply to a BDC's portfolio companies.⁷

B. General

The Proposed Rules represent a significant improvement over the current rules and go a long way toward ensuring that Rules 3-09, 4-08(g) and 10-01(b)(1) function in the manner that the Staff likely intended

⁴ Unless otherwise indicated, all rule and article references herein are to rules articles contained in the SEC's Regulation S-X.

⁵ See IM Guidance Update, September 2013, No. 2013-07, "Business Development Companies—Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries," available at <https://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf> (the "*BDC Portfolio Company Guidance*").

⁶ The following statement from the Proposing Release regarding Rule 3-05 (financial statements of acquired funds) and Article 11 (pro forma financial information for acquired fund transactions) applies equally to Rules 3-09, 4-08(g) and 10-01(b)(1):

Currently, there are no specific rules or requirements in Regulation S-X for investment companies relating to the financial statements of acquired funds. Instead, these entities apply the general requirements of Rule 3-05 and the pro forma financial information requirements in Article 11. However, investment company registrants differ from non-investment company registrants in several respects. For example, investment companies' income mainly stems from capital appreciation and investment income; investment companies are required to report their net asset value . . . using fair value for portfolio investments; and investment companies do not account for their investments using the equity method. As a result, investment companies have faced challenges applying the general requirements of Rule 3-05 and Article 11

See Proposing Release at 142.

⁷ See November 2015 Comment Letter.

when it issued the BDC Portfolio Company Guidance in 2013 (*i.e.*, to require enhanced financial disclosures about significant portfolio company investments of BDCs). We believe that the Proposed Rules will correct the false impression sometimes given to investors regarding the importance of particular portfolio investments due to the fact that the current rules oftentimes result in the requirement for BDCs to include additional financial disclosure in their SEC filings about insignificant portfolio company investments. In particular, we are of the view that the following proposed changes will greatly enhance the appropriateness and effectiveness of these disclosures on a go-forward basis:

- the use of a new income test which, among other things, combines the results of the income test and the investment test to ensure that insignificant portfolio company investments are not captured by the test due to unusual, non-recurring items impacting the BDC's financial results;
- the use of a multi-year averaging instruction which eliminates unusual, non-recurring items in a BDC's financial results from distorting the significance of a particular portfolio company investment, including inappropriately identifying otherwise insignificant portfolio companies as significant; and
- the elimination of the asset test because (i) the accounting methodology of BDCs and their portfolio companies is not consistent; BDCs fair value their assets, and most portfolio companies use historical cost⁸ and (ii) the inconsistency of the nature of investments lends itself to an inability to accurately measure significance; certain portfolio companies may be asset heavy but generate smaller returns than smaller asset-driven companies.

C. Recommendations

We believe that the SEC should undertake the following actions and make the following changes with respect to the Proposed Rules in order to fully achieve the intended benefits of the rulemaking:

Recommendation 1: *Codify Informal Positions Regarding Applicability of Rules 3-09, 4-08(g) and 10-01(b)(1) to the Portfolio Companies of BDCs*

As noted above, the Staff has issued many unwritten and uncatalogued informal interpretations with respect to the application of Rules 3-09, 4-08(g) and 10-01(b)(1) to the portfolio companies of BDCs. While we appreciate the Staff's efforts in this regard, we believe that it would be more appropriate if the SEC were to **formally** propose the adoption of these interpretations by following the Administrative Procedure Act's ("**APA**") notice and comment procedures. The remarks of SEC Commissioner Hester M. Peirce in her speech entitled "SECret Garden" at the 2019 SEC Speaks succinctly sets forth the reasons why the BDC industry thinks that it is important for the SEC to formally propose and adopt (or modify, revise, reject, etc.) these informal Staff positions in accordance with the APA.⁹ In this regard, if the Staff believes that it is important to provide greater transparency to investors with respect to certain portfolio company holdings of BDCs beyond what is currently required by the SEC's rules, then it should propose

⁸ See Proposing Release at 100.

⁹ See SECret Garden: Remarks by SEC Commissioner Hester M Peirce at SEC Speaks (April 8, 2019), available at <https://www.sec.gov/news/speech/peirce-secret-garden-sec-speaks-040819> ("I have grown increasingly concerned that this necessary [staff-level] guidance – due to a lack of transparency and accountability – may have turned into a body of secret law. This secret law, as a practical matter, binds market participants like law does but is immune from judicial – and even Commission review. We have our own secret garden – a tangle of staff pronouncements hidden beyond a wall without a readily accessible entrance") ("**SECret Garden Speech**").

rules that BDCs and other industry participants have the opportunity to review and comment on, as opposed to shoehorning BDCs into rules that were clearly not intended to apply to them. The result of proceeding down the informal guidance path has been the expenditure of a considerable amount of time, effort and expense by BDCs in figuring out how these rules should apply to them and breaking “down the walls of the secret regulatory gardens at the SEC” to learn about the Staff’s informal interpretations relating thereto.¹⁰ Unfortunately, this expenditure of time, effort and expense extends beyond such activities and ranges from seeking informal Staff waivers from these requirements to the incurrence, directly or indirectly, of the costs associated with complying with these rules, in each case, including in circumstances involving insignificant or previously disposed of portfolio company investments.

The concern expressed by SEC Commissioner Peirce in the SECRet Garden Speech that SEC rules do “not matter much in practice because firms operate instead under a set of published and unpublished . . . directives from staff” may have been in reference to the BDC Portfolio Company Guidance and the Staff’s unwritten and uncatalogued informal positions thereunder. In this regard, it is almost impossible for someone to read the BDC Portfolio Company Guidance and/or Rules 3-09, 4-08(g) and 10-01(b)(1) and come away with the conclusion that, among others, (i) these rules apply to the portfolio companies of BDCs given that all of the references therein are to “subsidiaries” and not portfolio companies; (ii) Rule 3-09 applies to majority-owned portfolio companies BDCs or (iii) Rule 4-08 applies to portfolio companies that are **controlled** by BDCs and that for purposes thereof the term “control” has the meaning set forth in Section 2(a)(9) of the 1940 Act.

Moreover, because these positions were forged behind closed doors at the SEC, there is a “lack of transparency and accountability”, as well as the ability to question or second-guess these informal Staff positions and, as a result, this situation raises the “immun[ity] from judicial—and even Commission—review” issue that SEC Commissioner Peirce noted in her SECRet Garden Speech.¹¹ For example, many BDC industry participants believe that it is inappropriate to use the 1940 Act definition of “control” (which presumes “control” exists where a BDC owns more than 25% of the voting securities of a portfolio company) for determining the types of portfolio companies subject to Rule 4-08(g) and not the definition of control used in Regulation S-X or other applicable **accounting** standards, which would have likely resulted in the use of a higher (and potentially more appropriate) ownership threshold. However, the BDC industry never had an opportunity to ask these and other questions given the manner in which these “rules” were promulgated by the SEC.

In light of the foregoing, we believe that it is imperative for the SEC to formally propose the codification of these interpretations, including the application of Rules 3-09, 4-08(g) and 10-01(b)(1) to BDCs, by following the APA in order to avoid all of the ills noted in the SECRet Garden Speech if it does not do so.

Recommendation 2: *Modify Rule 3-09 to Permit the Use of Unaudited Financial Statements*

We believe that Rule 3-09 should be revised to eliminate the audited financial statement requirement given that unaudited financial statements would serve the same purpose (*i.e.*, informing BDC investors about the financial condition and results of operations of significant majority-owned portfolio company investments), while avoiding the time, effort and expense spent by BDCs and their portfolio companies in obtaining audited financial statements. Many of the private, small and mid-sized companies in which

¹⁰ See SECRet Garden Speech.

¹¹ *Id.*

BDCs primarily invest do not routinely have their financial statements audited due to the significant costs associated therewith. Consequently, when a portfolio company investment triggers the audited financial statement requirement of Rule 3-09, the BDC and its portfolio company may need to obtain audited financial statements on short notice at a significant expense. Where the required audit cannot be completed by the SEC filing deadline, the BDC must seek a Staff waiver permitting the BDC to include unaudited financial statements for the portfolio company in its SEC filings in lieu of audited financial statements. In our experience, the Staff has generally granted such waiver requests. In light of the foregoing, we believe that the Rule 3-09 audited financial statement requirement should be revised to permit the use of unaudited financial statements in lieu of audited financial statements.

Recommendation 3: *Revise the Income Test in Proposed Rule 1-02(w)(2)(ii)(B) to Clarify that the Five Year Averaging Instruction Applies to Rule 1-02(ii)(A) and Rule 10-01(b)(1)*

Proposed Rule 1-02(w)(2)(ii)(B) would require a BDC to compute the income test using the average of the absolute value of the changes in net assets for the past **five fiscal years** to mitigate the potential adverse effects of the proposed income test for a BDC with insignificant changes in net assets resulting from operations for the **most recently completed fiscal year**. We note that the rule text makes using the 5-year average mandatory, but the Proposing Release states that it is permissive. The Proposing Release also suggests that using the 5-year average is an option for the 80% test in proposed Rule 1-02(w)(2)(ii)(A). We assume that the Proposing Release more accurately reflects the SEC's intent with respect to these two points and hope that the SEC clarifies them when adopting these rule changes. We also believe that the SEC should revise this instruction to clarify that it applies to the calculations required by Rule 10-01(b)(1) as well (*i.e.*, if a BDC has an insignificant change in net assets resulting from operations for its **most recently completed interim period** for which computations are being made for purposes of Rule 10-01(b)(1), then it should be able compute the income test using the average of the absolute values of such amounts for each of its past **five comparative interim periods**).

Recommendation 4: *Revise Rules 3-09, 4-08(g) and 10-01(b)(1) to Clarify their Inapplicability to Portfolio Companies No Longer Held by the BDC*

We believe that the above-referenced rules should be revised to clarify that they do not apply to portfolio company investments that are no longer held by the BDC at the applicable filing date. In this regard, once a portfolio company investment has been sold, the additional financial disclosure required by Rules 3-09, 4-08(g) and 10-01 (b)(1) are no longer of any relevance or importance to investors in the BDC and the BDC should not be required to seek a waiver from the Staff to omit this information, which is currently what it is required to do. This conclusion is supported by the fact that the BDC may not be able to obtain or have difficulty in obtaining the information needed to prepare the additional financial disclosures required by these rules for the portfolio company for inclusion in its SEC filings from the entity that now owns/controls the portfolio company.

Recommendation 5: *Clarify that the Proposed Income Test in Proposed Rule 1-02(w)(2)(ii) is Based on Pre-Tax (and not After-Tax) Change in Net Assets Resulting from Operations*

We note that proposed Rule 1-02(w)(1)(iii), the income test for operating companies, would use after-tax net income rather than pre-tax net income. We believe that the proposed income test for investment companies should continue to be based on pre-tax results for the following reasons:

- The Proposing Release's rationale for changing the income test for operating companies from pre-tax income to after-tax income is based, in part, on the fact that income taxes are generally a recurring and material line item for operating companies. In contrast, income taxes are generally not material for BDCs because substantially all BDCs elect to be treated as regulated investment companies for tax purposes and, consequently, pay little to no income tax. Therefore, we do not believe that this rationale applies to BDCs.
- The Proposing Release also notes that the use of pre-tax income may require operating company registrants to perform additional calculations to remove the tax impact from the figures reported in their financial statements, which generally report results on an after-tax basis. We do not believe that this rationale applies to BDCs. A BDC's statement of operations includes as separate line items any tax expenses/benefits.

* * *

We would welcome the opportunity to meet with the SEC and discuss these issues further. Please contact SBIA's Executive Director, BDC Council, Tonnie Wybensing, at [REDACTED] or [REDACTED] if we can provide additional assistance.

Sincerely,



Brett Palmer
President

cc: The Honorable Jay Clayton
The Honorable Robert J. Jackson Jr.
The Honorable Allison Herren Lee
The Honorable Hester M. Peirce
The Honorable Elad L. Roisman

Dalia O. Blass
Director, Division of Investment Management