November 30, 2015

Mr. Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-20-15 Effectiveness of Financial Disclosures about entities other than the registrant

Dear Mr. Fields,

Prospect Capital Corporation (“Prospect”, “we” or “us”) appreciates the opportunity to respond to the Securities and Exchange Commission’s (“Staff” or “Commission”) *Request for Comment on the Effectiveness of Financial Disclosures about Entities Other Than the Registrant*. We understand the importance of the required disclosures in providing transparency into the financial health of entities other than the registrant, and would like to share our response from the perspective of a business development company (“BDC”) as registrant.

Prospect is a financial services company that primarily lends to and invests in middle market privately-held companies. We are a closed-end investment company incorporated in Maryland. We have elected to be regulated as a BDC under the Investment Company Act of 1940 (“ICA”). As a BDC, we have elected to be treated as a regulated investment company (“RIC”), under Subchapter M of the Internal Revenue Code of 1986. We were organized on April 13, 2004 and were funded in an initial public offering completed on July 27, 2004. As such, the focus of our response is on the questions asked by the Commission that pertain to investment companies, specifically:

1. Changes to the disclosure requirements.
2. Changes to the significance tests.
3. Disclosure of financial statements and other information.

1. Changes to the Disclosure Requirements

Prior to the last five years, BDC’s generally did not apply Rule 3-09 and Rule 4-08(g) of Regulation S-X (“Rule 3-09 and Rule 4-08(g)”) to their annual and quarterly financial statements and reporting. Recently the Staff has required BDCs to apply Rule 3-09 and Rule 4-08(g) to their annual and quarterly financial statements and reporting.

We believe that investment companies, including BDCs, should not be subject to the requirements of Rule 3-09 and Rule 4-08(g). The specific U.S. generally accepted accounting principles (“US GAAP”) that investment companies are subject to differ from operating companies. For investment companies, the disclosure requirements when applying Rule 3-09 and Rule 4-08(g) do not provide a reader of the financial statements meaningful information.

Under ASC 946 *Financial Services – Investment Companies*, investment companies (including BDCs) are generally not required to apply the equity method of accounting[1] nor to consolidate an operating company investee[2] and

[1] ASC 946-323-45-2 states “Equity method of accounting for an operating entity is appropriate only when that entity provides services to the investment company, and in such cases, the investment company’s non-controlling ownership interest in the

instead are required to account for their investments at fair value[3]. Moreover, as explained in Note 1 to Section 2405.2 of the SEC's Division of Corporate Finance *Financial Reporting Manual*, the elimination of any exception to consolidation left Rule 3-09 inoperable with respect to unconsolidated subsidiaries. It can be deduced that Rule 3-09 was never intended to apply to unconsolidated subsidiaries of investment companies, including BDCs, because investment companies were never permitted to consolidate any investment other than investment company subsidiaries and companies providing services primarily to the investment company[4].

2. Changes to Significance Tests

If the Staff disagrees that investment companies should not be exempted from Rule 3-09 and Rule 4-08(g), we recommend a modification to the measures applied in determining significance and the resulting disclosure requirements for investment companies, particularly BDCs, as discussed further below.

We agree with the Staff's assessment of the challenges faced with providing reliable, comparable and timely financial information. We recognize the difficulty in balancing the necessity to disclose financial information with a desire to limit the financial and reporting burden of registrants in providing such data. With that in mind, we recommend the Staff consider a principles-based approach for investment companies that streamline the calculations and provides a basis for transparency in the determination of the significance.

The Staff should consider the following modifications specifically tailored for investment companies:

- Limit the scope of subsidiaries to controlled investees;
- Eliminate the requirement for the consolidation of the subsidiaries;
- Eliminate the asset test; and
- Revise the income test.

Limit the Scope of Subsidiaries to Controlled Investees

Rule 3-09 and Rule 4-08(g) should be limited to investees that investment companies "control". As defined in Section 2(a)(9) of the ICA, control means the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company. Section 2(a)(9) further states that control is presumed through an ownership, either directly or through one or more controlled companies, of more than 25% of the voting securities of a company.

Historically, the thresholds used under US GAAP were a voting interest that exceeded (1) 50%[5] (in which case control was presumed to exist and thus consolidation was required) and (2) 20%[6] but less than 50% (in which case significant influence was presumed and equity method accounting was required). Therefore, given the accounting rules and voting interest levels with which Rule 3-09 and Rule 4-08(g) were associated, if investments companies are to be subject to these rules, we ask the Staff to consider <u>formally</u> restricting the scope of investees for evaluation of significance under Rule 1-02(w) of Regulation S-X ("Rule 1-02(w)") to operating company investees that an investment company controls, as defined under the ICA, and not as used under US GAAP.

Further, we ask the Staff to consider limiting the analyses by an investment company to determine its significant subsidiary investee to controlled investees that exist as of the applicable balance sheet date. If an investee was

operating entity qualifies for use of the equity method of accounting and should therefore use the equity method of accounting for that investment."

[2] ASC 946-810-45-2 and Rule 6.03(c) of Regulation S-X.

[3] ASC 946-323-45-1.

[4] ASC 946-810-45-3.

[5] ¶2 of ARB 51, *Consolidated Financial Statements*, now codified in ASC 810-10-15-8.

[6] ¶17 of APB 18, *The Equity Method of Accounting for Investments in Common Stock*, now codified in ASC 323-10-15-8.

disposed during the reporting period, providing financial statements or summarized financial information for such an investee that meets the income test but that is no longer a portfolio company as of the balance sheet date is not meaningful to users of the financial statements in assessing the financial conditions or future earning capacity of the investment company.

Restricting the scope to controlled investees of an investment company as of the applicable balance sheet date reduces the costs and burden of compliance for investment companies, and provides results that are more meaningful for disclosure purposes. In addition, investment companies may not have access to such data once the investment is sold.

Eliminate the Requirement for the Consolidation of the Subsidiaries

To comply with the requirements of Rule 3-09 and Rule 4-08(g), the determination of a "significant subsidiary" pursuant to Rule 1-02(w) requires a registrant to consolidate its subsidiaries in accordance with US GAAP. As previously discussed, this presents a challenge and is onerous for investment companies, particularly BDCs, to comply as BDCs (i) are not required to consolidate noninvestment company portfolio companies; (ii) typically do not have access to the books and records of the underlying operating companies to perform and prepare a proper consolidation under US GAAP; and (iii) would otherwise incur significant costs to prepare such consolidated statements, while being subject to significant time constraints in order to comply with their reporting deadlines. Accordingly, based on the foregoing challenges for investment company registrants, we recommend the Staff <u>formally</u> eliminate for investment companies the consolidation requirement implied in Rule 1-02(w) to determine a significant subsidiary.

Eliminate the Asset Test

The measures for significance under Rule 1-02(w) should be modified to metrics that are more relevant to investment companies and their investors such as the level of (i) investment and (ii) investment income. Investments substantively constitute the total assets of an investment company and thus the asset test should be eliminated under this principle. Further, under the premise that the consolidation requirement to determine significance of a subsidiary is eliminated, an investment company should be allowed to use the as-reported amounts on its financial statements for the test.

Revise the Income Test with an Investment Income Test

We agree with the Staff's evaluation of the challenges faced in applying the income test (which for investment companies, "income" represents the "net increase (or decrease) in net assets resulting from operations"). We note that currently there is disparity in the Staff's position for the calculation of the numerator and the denominator for the income test that is applied by BDCs. Given the different operating performance metrics and exposure to significant valuation volatility from quarter to quarter, we suggest that the basis for determining a significant subsidiary of an investment company should be on a measure other than income, such as income as reported on the investment company's financial statements for and from such operating company controlled investees. Specifically, we believe that a more appropriate measure is an investment company's *investment income*. For purposes of this discussion, investment income includes interest income, dividend income, and other income constituting an investment company's investment income as presented in accordance with the accounting and reporting requirements for investment companies (bullet 1 of ASC 946-225-S99-1 and Rule 6-07.1 of Regulation S-X). This approach is consistent with the notion in Section 31 of the ICA as it minimizes the compliance burden and avoids unnecessary recordkeeping.

Rationale for Using Investment Income

The fundamental characteristics on an investment company are that[7]:

- It obtains funds from one or more investors and provides the investor(s) with investment management services;
- It commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income or both; and
- It or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

These fundamental characteristics are also rooted in the "fair value" accounting and reporting applied by investment companies since the advent of the ICA in 1940. In contrast, the premise for consolidation (or use of the equity method of accounting) of an operating company by an investment company is where the portfolio company provides services to such investment company. Such a premise does not exist for the consolidation or equity method accounting rules that non-investment companies apply.

Hence, based on the fundamental characteristics of an investment company and given the premise for consolidation by investment companies for their investment in operating companies, the income test that investment companies apply for Rule 3-09 and Rule 4-08(g) should be different from those of non-investment companies.

Investors in BDCs typically invest is these vehicles for income distributions (i.e. an investment in a BDC is akin to an investment in a fixed income instrument) whereby interest income is earned and distributed periodically over the course of the year[8]. Furthermore, the stock prices of publicly traded BDCs are influenced by investors' view of a BDC's income earning capacity and distributions thereof through dividends. Additionally, an adviser to a BDC earns performance-based compensation (i.e., an incentive fee) that is influenced by the level of investment income earned by the BDC. Based on the preceding, and the reasons listed below, we urge the Staff to consider replacing the income test, as used today in the rules, with an *investment income* test which is based on the earnings by a BDC from its investment in a controlled operating portfolio company (as the numerator) and the total investment income earned by the BDC (as the denominator). Such metric would be most meaningful and transparent for the following reasons:

- Investment income is readily available and verifiable;
- Functionally easy to calculate;
- Variability is eliminated in a BDC's net increase (decrease) in net assets resulting from operations from significant changes in fair value;
- Investment income is the key measure to users of a BDC's financial statements in order to evaluate performance and the ability to pay dividends and therefore more closely aligns the income significance test to how a user of the financial statements evaluates the significance; and
- Increases comparability of a significant portfolio company between BDCs by not reducing investment income by operating expenses, which vary by BDCs based on the extent of leverage used and the operating expense structure (i.e. internally managed vs externally managed).

---

[7] ASC 946-10-15-6.

[8] Investment companies, including BDCs, are RICs for tax purposes. To qualify for special tax treatment, a RIC must distribute at least 90% of its taxable income to its investors for the fiscal year. The major source for a RIC's taxable income generally comes from its investment income.

The Problem with Including Changes in Fair Value

Generally, we believe the use of net increase (decrease) in assets resulting from operations is not appropriate. This metric, which is equal to "income" under the current income test, includes changes in fair values. The fair values and related changes in unrealized gains (losses) of an investment company's controlled portfolio companies are subject to significant volatility from quarter to quarter due to changes in observed multiples of comparable publicly traded companies or observed transactions prices as well as changes in the operating performance of such portfolio companies, which is magnified by the level of multiple applied to such performance metric (e.g. EBITDA measures). The following are other disadvantages for using changes in unrealized gains (loss) which is driven by changes in fair values:

- Significant depreciation of other portfolio company investments could result in a small net increase (decrease) in net assets resulting from operations causing many otherwise insignificant portfolio companies to meet the significance test;
- Significant depreciation of a portfolio company could result in a portfolio company meeting the significance test even though the investment company's fair value investment in such a portfolio company may now result in an immaterial amount;
- Distributions from a portfolio company that are recorded as dividend income by the investment company could result in a depreciation in the fair value of such portfolio company that could impact the significance test although the total impact (dividend income and unrealized depreciation) recognized from such portfolio company by the investment company is zero; and
- Significant changes in a portfolio company's valuation are sometimes driven by factors outside of the portfolio company's controls and operating results, e.g. significant changes in market multiples used in the valuation can have a significant effect on the changes in valuation despite little or no change operationally at the portfolio company.

Alternative to the Calculation Under the Current 'Income' Test

If the Staff believes that the inclusion of realized and unrealized gains need to be included in the significance test, the current income test is still not appropriate, primarily due to the fact that the numerator and denominator are not calculated on the same basis. For a test that incorporates realized and unrealized gains or losses, the gains and losses need to be included at their absolute value, thereby not reducing either the numerator or the denominator for losses. In addition, other expenses also need to be excluded from both the numerator and the denominator in the calculation.

We offer the following alternative method for the calculation under the income test:

- Numerator – Investment Income (as defined above) for the investment plus the absolute value of any realized gains or losses for the investment plus the absolute value of any unrealized realized gains or losses for the investment; divided by
- Denominator – Total Investment Income for the BDC plus the aggregate absolute values of any realized gains or losses on <u>each</u> investment plus the aggregate absolute values of any unrealized realized gains or losses for on <u>each</u> investment.

3. Disclosure of financial statements and other information

Providing financial statements or financial information of deemed significant portfolio companies of an investment company are neither useful nor reasonably informative for users of an investment company's financial statements because, as noted by the Staff, neither the operating results nor the financial condition of the portfolio company is directly included or traceable to an investment company's set of financial statements. For example, a portfolio company's balance sheet information does not correlate to the fair value recorded on the investment company for such portfolio company, nor the result of the portfolio company's net income (or a share thereof) included on the investment company's statement of operations. Operationally, obtaining the portfolio company's audited financial statements or accurate unaudited financial statements on a timely basis is arduous and challenging for many BDCs as some portfolio companies do not formally prepare quarterly US GAAP financial statements and/or their annual audited financial statements are not completed timely. Additionally, the fiscal year end of some portfolio companies is not the same as the investment company's fiscal year end (sometimes more than three months apart), which means additional costs to otherwise have audited financial statements or US GAAP interim financial statements for such portfolio companies in order for the investment company to comply with Rule 3-09 and/or Rule 4-08(g). Furthermore, the usability of the investee's financial statements is further diminished as income from the investee is fully disclosed by the BDC along with significant risks and valuation methodologies.

Regulation S-X, Article 12-14, *Investments in and advances to affiliates*, requires investment companies, including BDCs, to provide a schedule that includes specific information for each controlled portfolio company. Such information includes fair value at the reporting date, and interest income and dividend income during the reporting period, whereby the totals of these items agree to the balance sheet and to the income statement, respectively, of the investment company. This schedule provides the transparency on investment income earned by controlled portfolio companies. Therefore, in lieu of attaching financial statements or providing summarized financial information of significant subsidiaries, we recommend that the Staff consider the information required by Rule 12-14 to be sufficient for a controlled portfolio company, or expand on the content of Rule 12-14 to also include other investment income, realized gain (loss) and change in unrealized gain (loss) for each controlled portfolio company. These disclosures also allow for the transparency to users of the investment company's financial statements in assessing which portfolio company is significant to the investment company's operating performance and financial condition.

If the Staff objects to the suggestion above and believes Rule 3-09 and 4-08(g) financial information is needed, we ask the Staff to formalize the Division of Investment Management's IM Guidance Update No. 2013-07, *Business Development Companies—Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries*[9] into the rules for investment companies. This Guidance allows a BDC to disclose summarized financial information in the notes to its financial statements only for each subsidiary that meets the test for purposes of Rule 4-08(g) rather than the disclosure of summarized financial information for all unconsolidated subsidiaries when any unconsolidated subsidiary, or combination of unconsolidated subsidiaries met the requirements under Rule 4-08(g) for such disclosures.

Furthermore, if a portfolio company meets the investment income (or income test) but was no longer held as of the balance sheet date, providing financial statements or summarized financial information for such portfolio company is not necessary to inform investors about the investment company's income prospects going forward from such portfolio company. Therefore, this information should not be required for portfolio companies disposed of during the reporting period.

In conclusion, we recommend to the Staff that investment companies be excluded from the requirements under Rule 3-09 and 4-08(g). If the Staff disagrees, we recommend a modification to the current rules such that 1) only controlled investees are considered for consolidation, 2) eliminate the consolidation requirement for subsidiaries, 3) eliminate the asset test and, 4) revise the income test.

---

[9] http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf

We appreciate the opportunity to present our comments for consideration. I am available to discuss our comments and answer any questions at [redacted].

Sincerely,

/s/ Brian H. Oswald

Brian H. Oswald
Chief Financial Officer
Prospect Capital Corporation