May 2, 2019

Vanessa Countryman  
Acting Secretary  
Securities and Exchange Commission  
100 F Street, NE Washington, D.C. 20549-1090

Re: File Number S7-27-18: Fund of Funds Arrangements, Proposed Rule

Dear Ms. Countryman:

The Coalition for Business Development\(^1\) appreciates the opportunity to provide the BDC industry’s views regarding several questions contained in the rule proposal noted above about the impact of the SEC’s “Acquired Fund Fees and Expenses” (AFFE) disclosure obligations on exchange-traded BDCs.\(^2\) This letter is limited in scope to responses to those questions as they relate to exchange-traded BDCs. Correcting the distortive impact of the AFFE disclosure obligations on these BDCs is one of the Coalition’s highest priorities, and we applaud the SEC for requesting comment on that impact. Indeed, the Coalition has filed an application (Application) with the SEC requesting an exemption for exchange-traded BDCs from the meaning of the term “Acquired Fund” for purposes of AFFE disclosure obligations.\(^3\)

**Background**

Congress established BDCs in 1980 with a unique mandate – to make capital available to small, developing and financially troubled companies that do not have ready access to the public capital

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1. The Coalition is a member-driven, Washington-based association that advocates exclusively on behalf of business development companies (BDCs) to expand BDCs’ ability to provide necessary growth capital to small- and middle-market Main Street businesses so they can expand, invest, and create jobs. The Coalition is the successor to the Coalition for Small Business Growth, an ad-hoc coalition of BDCs and other market participants that has produced research and data on the BDC industry, and championed modernization of BDC regulation. Driven by the vision and input of our members, the Coalition’s mission is to increase awareness of the value of BDCs to Main Street businesses among legislators, regulators, and media; to promote federal policy changes that enable BDCs to expand their lending; and to conduct and publish research on the efficacy of BDC activities and regulation. For more information about the Coalition, please visit [www.coalitionforbusinessdevelopment.com](http://www.coalitionforbusinessdevelopment.com).


markets or other forms of conventional financing. These small and medium-sized businesses are vital to promoting job formation and growth of the U.S. economy as a whole.

To satisfy their mandate, BDCs must invest a certain amount of their assets in eligible portfolio companies, typically U.S. issuers that are either privately owned or have less than $250 million in market capitalization. A supportive equity market, in the form of access to retail and institutional investors, is critical to fully realize Congress’s goal in creating BDCs, but the AFFE disclosure obligations have inadvertently limited BDCs’ potential to do just that.

As a consequence of the application of the AFFE rule to BDCs, index providers removed BDCs from indices, causing a dramatic reduction in institutional ownership. In 2014, the MSCI, Russell and S&P indices all removed BDCs from their respective indices primarily because of the AFFE disclosure requirement. We believe this consequence was not intended by, nor likely was foreseeable by, the SEC when it and its staff applied the AFFE disclosure obligations to investments in BDCs.

Our Application requested relief for exchange-traded BDCs for two primary reasons:

1. mutual fund investors are harmed by application of the AFFE rule to investments in a BDC’s tradeable securities because:
   - the artificial exclusion of components of indices that are consistent with the investment objectives of the indices, as a consequence of the application of the AFFE rule to BDCs, has caused a dramatic reduction in institutional ownership in BDCs, limiting BDCs’ ability to support the funding needs of businesses, as Congress intended;
   - the AFFE rule results in limited access to pooled investments in BDCs;
   - institutional owners’ participation in governance of BDCs has been significantly hampered and consequently has negatively impacted retail shareholders; and

2. application of the AFFE rule to investments in a BDC’s tradeable securities requires a double-counting of the BDC operating expenses, resulting in grossly overstated expenses of funds that invest in BDCs, and potentially misleads mutual fund investors.

Responses to SEC Questions about AFFE’s Disclosure for BDCs

We respond below to the SEC’s specific questions about the impact of the AFFE disclosure as those questions relate to BDCs. We do not respond to the SEC’s questions that do not relate to BDCs or that ask for perspectives from market participants other than BDCs.

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Question: An acquiring fund is currently required to disclose the fees and expenses it incurs indirectly from investing in shares of one or more acquired funds. In Form N–1A, for example, an open-end fund investing in another fund is required to include in its prospectus fee table an additional line item titled “Acquired Fund Fees and Expenses” (“AFFE”). The AFFE disclosure was designed to provide investors with: (i) a better understanding of the actual costs of investing in a fund that invests in shares of another fund; and (ii) relevant information to compare directly the costs of investing in alternative funds of funds or of investing in a fund that invests in one or more other funds to a fund that does not. Since we adopted the AFFE disclosure requirement, however, concerns have been expressed with respect to disclosure of fees and expenses of certain acquired funds, e.g., private funds other than hedge funds, and BDCs. Has the AFFE disclosure requirement been effective? Why or why not?

Response: We acknowledge and support the SEC’s goals of promoting transparency for investors. We agree that investment company shareholders should have readily available material information about their investments, including the costs of investment. As it relates to exchange-traded BDCs, however, the SEC’s policy goal has not been met. Worse, the effect has been to preclude investments from occurring. This is because the AFFE disclosure obligation led index providers to remove BDCs from their indices, causing a dramatic reduction in institutional ownership. As we note in our Application, the MSCI, Russell and S&P indices all removed BDCs from their respective indices in 2014, primarily because of the AFFE disclosure requirement. In all, the decisions by these index providers affected more than 30 BDCs at the time.

The SEC does not require a mutual fund to incorporate into its expense table the expenses associated with managing and running an operating company, nor should it. BDCs operate in many ways like operating companies (and REITs, which also are not subject to AFFE disclosure), and this disclosure regime has served the investing public for almost 80 years, since enactment of the Investment Company Act of 1940, as amended (1940 Act). We respectfully urge the SEC to use the same approach for exchange-traded BDCs.

Question: Do investors understand the AFFE disclosure? Has the AFFE disclosure requirement helped investors understand the fees and expenses associated with their investment in an acquiring fund? If so, how? For example, has the AFFE disclosure helped in fund selection or fund comparison? Are there ways that we could improve the AFFE disclosure consistent with our intent in adopting the AFFE disclosure requirement? Can we make the disclosure easier to understand or more comparable across pooled vehicles of the same or different types? Are there additional disclosures (e.g., as words, graphics, or pictures) that we should require to clarify how AFFE is calculated in order to help investors to understand the fees and expenses associated with such an investment?
Response: We do not purport to speak for all investors, but wish to draw the SEC’s attention to statements by certain institutional investors who have stated that AFFE disclosure about BDC investments is incorrect, at best. For example, a recent Vanguard prospectus explained:

Like an automaker, retailer, or any other operating company, many BDCs incur expenses such as employee salaries. These costs are not paid directly by a fund that owns shares in a BDC, just as the costs of labor and steel are not paid directly by a fund that owns shares in an automaker.  

The Vanguard prospectus went on to say that an acquiring fund is nevertheless required to include BDC expenses in an acquiring fund’s expense ratio, and to explicitly state:

[t]he expense ratio of a fund that holds a BDC will thus overstate what the fund actually spends on portfolio management, administrative services, and other shareholder services by an amount equal to these Acquired Fund Fees and Expenses.  

Further, the application of the AFFE disclosure obligations to BDCs requires a double-counting of BDC operating expenses, resulting in grossly overstated expenses of funds that invest in BDCs, and potentially misleads mutual fund investors. This double-counting may complicate fund selection and fund comparison for retail investors.

In our view, the AFFE rule, as currently applied, distorts the actual costs of investing in BDCs and does not provide investors with an accurate comparison of costs of investing in BDCs. The goal of the AFFE rule is not being achieved with respect to BDCs, as it does not provide transparency to the costs of investing in underlying funds. We believe a better way to both promote transparency and institutional investor investment in exchange-traded BDCs is to grant the relief requested in our Application, conditioned on an alternative disclosure methodology – outside the “acquiring fund’s” expense table – that conveys the expenses associated with investing in BDCs.

Question: For purposes of the AFFE disclosure, the definition of “acquired funds” includes investment companies and private funds. Is AFFE disclosure appropriate for all types of acquired funds or should we exempt certain types of acquired funds from the definition of acquired fund for purposes of AFFE disclosure? If so, which types of acquired funds should be exempted and why?

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6 See Vanguard Explorer Fund Prospectus, “Plain Talk About Business Development Companies and Acquired Fund Fees and Expenses” (Feb. 23, 2018).

7 Id.
Response: The Coalition believes exchange-traded BDCs should not be included within the meaning of the term “acquired fund” for purposes of AFFE disclosure. We provide the rationale in our Application, and summarized above, explaining why it is appropriate to do exclude exchange-traded BDCs. One such reason is that BDCs are similar in operation to real estate investment trusts (REITs), which appropriately do not fall within the meaning of the term “acquired fund.” Like REITs, BDCs are characterized as nontraditional investments that are designed to provide yield to investors. BDCs and REITs are taxed identically under Subchapter M of the Code, and, due to these similarities, they are often accepted in the same distribution channels. A REIT’s fee and expense structures are materially identical to those of BDCs. The staff, rightly, does not apply AFFE disclosure to an acquiring fund’s investment in securities issued by REITs. Our Application explains that it is incongruous to exclude REITs but not BDCs from the meaning of the term “acquired fund.” The Application requests that BDCs be excluded because, like REITs, they function like operating companies and not like traditional investment vehicles, which were at the heart of the Commission’s policy rationale for the requirement of the AFFE disclosure.

Question: Is AFFE disclosure appropriate for every type of fee and expense of every type of acquired fund or should specific types of acquired fund fees or expenses be excluded from the disclosure? If so, which fees and/or expenses and why? Some have commented, for example, that expenses of certain funds are operationally distinct and thus do not raise expense duplication concerns. For example, closed-end funds, and particularly BDCs, finance a portion of their portfolios through borrowing, which is not typical for open-end funds, and the interest paid is included in the fund’s expense ratio. Would the exclusion of certain fees or expenses affect the way that acquired funds characterize expenses? Are there concerns, other than expense duplication, that warrant disclosure of acquired fund fees and expenses?

Response: We appreciate the ability of the SEC to think creatively about the operation of the AFFE disclosure obligations, as expressed in the question above. We do not believe a selective pro forma presentation of fees and expenses would serve investors well. We believe such an approach would add a new level of operational complexity and administrative burden, and likely investor confusion, than is even present today with respect to institutional investments in exchange-traded BDCs. We urge the SEC to avoid adding yet more complexity to an already complex, confusing, and (in our view) misleading set of disclosures about investments in exchange-traded BDCs.

Alternatively, if the SEC does determine to include only certain fees and/or expenses in AFFE disclosure, such disclosure should apply to all acquired funds and not just BDCs.

Question: Should we instead require two disclosures: One without such fees and expenses and one with such fees and expenses?
Response: Again, we applaud any attempt by the SEC to think creatively about the operation of its AFFE disclosure obligations. We believe a dual-disclosure approach could conceptually alleviate the unintended consequences of the application of those obligations to the exchange-traded BDC industry and to mutual fund investors. If the SEC determines to pursue this approach, we urge the SEC to adopt the view that simpler is often better (and less confusing) for investors and that any action by the SEC will only be effective in promoting institutional investments in BDCs if the result is re-inclusion of BDCs into indices.

Question: Alternatively, should the AFFE disclosure be aligned with the restrictions imposed by Congress on the acquisition limitations imposed by section 12(d)(1)(A)? For example, should we require AFFE disclosures only for acquiring funds that invest in acquired funds in excess of the limits of section 12(d)(1)(A)? Would such an alternative disclosure allow investors to fully understand the acquiring fund’s fees and expenses?

Response: We do not believe such an approach would be effective to promote re-inclusion of BDCs into indices. At a conceptual level, it also should not make a difference in terms of expense disclosure if an investment is above any given level.

Question: Has the AFFE disclosure requirement affected investment or other decisions of acquiring funds? If so, in what ways?

Response: As noted above and in our Application, we believe the AFFE disclosure obligation has directly reduced institutional ownership of BDCs. In a future amendment to the Application, we intend to provide data showing that institutional ownership of exchange-traded BDCs has materially declined since adoption of the AFFE obligation, from about 45% at the end of 2006 to approximately 29% at the end of 2018.
Again, thank you for the opportunity to provide the industry’s views regarding the questions contained in the Fund of Funds rule proposal about the impact of the SEC’s AFFE disclosure obligations on exchange-traded BDCs. If you have any questions regarding our comments or would like additional information, please contact me at [redacted] or [redacted].

Sincerely,

Joseph Glatt
Chairman
Coalition for Business Development

Cc: Paul Cellupica, Deputy Director and Chief Counsel
    Penelope Saltzman, Senior Special Counsel
    Division of Investment Management