INVESTMENTS℠

May 2, 2019

Via electronic submission to rule-comments@sec.gov

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Release Nos. 33-10590; IC-33329; File No. S7-27-18; RIN 3235-AM29
FS Investments Comments on the Proposed Rule regarding Fund of Funds Arrangements

Dear Mr. Fields:

Franklin Square Holdings, L.P., d/b/a FS Investments ("***FS***"), appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (the "***SEC***" or the "***Commission***") proposed rule and rule amendments relating to fund of funds arrangements (the "***Proposed Rule***").[1]

This letter, which focuses on the Proposed Rule's effects on Business Development Companies ("***BDC***"), their investors and the private and small-cap U.S. businesses for which BDCs serve as a critical source of financing, makes the following recommendations relating to the Proposed Rule and the request for comments contained in the Proposing Release:

- the SEC should exempt BDCs from the definition of "Acquired Fund" under Forms N-1A, N-2, N-3, N-4 and N-6 (the "***Forms***");

- the SEC should maintain the exclusion of private and foreign funds from eligibility under the Proposed Rule and should explicitly prohibit certain schemes designed to evade the 3% cap;

- the SEC should eliminate the "pass-through voting" option under the Proposed Rule and permit only "mirror voting;"

[1] SEC, *Fund of Funds,* Rel. No. 33-10590 (Dec. 19, 2018) (the "***Proposing Release***").

- the SEC should provide exemptions to the redemption limits under the Proposed Rule for transactions between affiliated funds and for legitimate, routine rebalancing purposes; and

- the SEC should revise the three-tiered fund of funds limitation condition in the Proposed Rule to permit acquired BDCs to invest in private funds.

FS, founded in 2007 in Philadelphia, Pennsylvania, manages alternative investment funds. Our mission is to enhance mainstream investors' portfolios by providing access to asset classes, strategies and asset managers typically available only to wealthy individuals and large institutional investors. In servicing our primarily retail shareholder base, we also strive to set the industry standard for best practices, with a focus on transparency, investor protections and education for investment professionals and their clients. We manage six BDCs, one Real Estate Investment Trust, one registered closed-end fund, two interval funds and one mutual fund. In all, we manage more BDC assets, in both traded and non-traded BDCs, than any other manager in the industry.[2]

Background on BDCs

A BDC is a type of closed-end investment fund created by Congress through the enactment of the strongly bi-partisan Small Business Investment Incentive Act of 1980 ("***SBIIA***").[3] Congress' stated objective in creating BDCs was to encourage the establishment of new capital vehicles that would invest in, and increase the flow of capital to, small and mid-sized companies in the United States.[4] As such, the Investment Company Act of 1940, as amended (the "***1940 Act***"), generally requires BDCs to invest at least 70% of their total assets in the securities of "eligible portfolio companies," which the 1940 Act generally defines as private U.S. operating companies and public U.S. operating companies with public market capitalizations of less than $250 million.[5] Consistent with Congress' goal of providing support to small and mid-sized U.S. companies, the 1940 Act also requires BDCs to make available significant managerial assistance to such portfolio

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[2] FS currently manages six BDCs with aggregate assets under management of approximately $20.6 billion as of December 31, 2018. FS KKR Capital Corp. (formerly known as FS Investment Corporation), our first fund which launched in January 2009, listed its shares of common stock on the NYSE in April 2014. On December 19, 2018, Corporate Capital Trust, Inc. merged with FS KKR Capital Corp., creating the second largest publicly traded BDC. With the closing of this merger, FS Investment Corporation was renamed FS KKR Capital Corp. and now trades on the New York Stock Exchange under the ticker symbol "FSK." FS KKR Capital Corp. is managed by FS/KKR Advisor, LLC, a partnership between FS Investments and KKR Credit Advisors (US) LLC.

[3] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980); *see also* S. REP. NO. 96-958 (1980); H.R. REP. NO. 96-1341 (1980). The SBIIA was approved by the U.S. House by a vote of 395-1 and by unanimous consent in the U.S. Senate.

[4] *See* S. REP. NO. 96-958, at 1, 3 (1980).

[5] *See* 15 U.S.C. § 80a-2(a)(46), and 17 C.F.R. § 270.2a-46.

companies.[6] In complying with these regulatory requirements, BDCs provide a significant level of capital and assistance to small and middle market U.S. companies.

After the passage of the SBIIA, changes in banking regulation[7] caused banks to significantly curtail lending, particularly to smaller and private companies that lack credit ratings or are otherwise subject to greater credit risk. BDCs have helped to fill this void and have emerged as a vital source of financing for small and mid-sized U.S. businesses. In recognition of this fact, Congress recently passed the Small Business Credit Availability Act of 2018 (the "***SBCAA***"), which facilitated the ability of BDCs to raise capital through additional borrowing and streamlined securities registration rules. As of the date of this letter, the BDC industry was comprised of over 90 BDCs with over $100 billion in combined assets under management.

BDCs also provide a number of important benefits to investors. For example:

- BDCs generally offer a meaningful and consistent source of income to their investors despite the current low interest rate environment. This feature is particularly important to income-seeking investors.

- BDCs allow smaller investors, including retail investors, to access private and middle market company credit, a differentiated asset class otherwise available only to wealthy individuals and large institutions (*e.g.,* through investments in private equity funds, hedge funds, or direct investments).

- Exchange-traded BDCs can provide exposure to an illiquid asset class (private credit) in a liquid format.

- BDCs are subject to substantial legal and regulatory requirements,[8] including, *inter alia*, fiduciary duties, restrictions on transactions with affiliates, auditing and disclosure requirements, and governance requirements.

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[6] *Id*. §80a-2(a)(48)(B).

[7] Including the repeal of the Glass-Steagall Act of 1933 (which led to a wave of bank consolidations), heightened capital and liquidity requirements imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the U.S. implementation of the international Basel III Accord (which limits banks' ability to hold unrated debt).

[8] BDCs, together with their advisers, are subject to regulation under the Securities Act of 1993, as amended, the Securities Exchange Act of 1934, as amended, the Investment Company Act of 1940, as amended, the Investment Advisers Act of 1940, as amended, and SEC rules promulgated under each of the foregoing. Additionally, non-traded BDCs are further subject to regulation by up to 54 state and territorial securities regulators and the distribution of non-traded BDC securities is subject to regulation by the Financial Industry Regulatory Authority.

- BDCs provide a high level of transparency to investors and the market through detailed quarterly disclosure that includes, *inter alia*, mark-to-market valuation of portfolio holdings.

I. FS recommends the Proposed Rule be revised to exempt BDCs from the definition of "Acquired Fund" for purposes of Acquired Fund Fees and Expenses ("AFFE") disclosure

The SEC should exempt BDCs from the definition of "Acquired Fund" under the Forms for the reasons set forth below.

The AFFE Rule was intended to enhance investor understanding of the actual costs of investing without having an adverse impact on capital formation – it has fallen short in both respects.

In 2006, the SEC adopted form amendments that require a registered fund or BDC to disclose as an additional line item in its prospectus fee table its *pro rata* share of the operating expenses charged by underlying funds in which the acquiring fund invests (the "***AFFE requirements***" or "***AFFE rule***"). Consequently, this line item expense is added to the acquiring fund's other operating expenses thereby increasing the acquiring fund's overall operating expense ratio, *i.e.,* the "bottom line" expense ratio shown in the prospectus fee table. The adopting release states that by showing investors the indirect expenses associated with underlying fund investments the AFFE requirements are designed to provide investors with (i) "a better understanding of the actual costs of investing in a fund that invests in other funds" and (ii) "the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund."[9]

An unintended consequence of the AFFE Rule's inflation of acquiring fund expense ratios has been to discourage sponsors of mutual funds, exchange-traded funds ("***ETFs***"), and other registered investment companies from investing in BDCs. To minimize the effect of AFFE on the total operating expenses disclosed in the prospectus fee tables of funds that track indices, the fund industry pressured index providers to drop BDCs from their indices. In March 2014, for example, Russell announced that BDCs would no longer be eligible for inclusion in its family of indices. Russell cited the "distortive impact" of the AFFE requirements as the reason for this decision.[10] S&P and others followed suit later

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Taken together, these and various other regulations applicable to BDCs make BDCs one of the most transparent and highly regulated investment vehicles available to investors today.

[9] SEC, *Funds of Funds Investments*, Rel. 33-8713 (Jun. 20, 2006) ("***Funds of Funds Adopting Release***"), at 41.

[10] Barrons, *Russell Sets Terms for Booting BDCs: Should You Buy the Dip?* (Mar. 4, 2014) (Brendan Conway), available at https://www.barrons.com/articles/russell-sets-terms-for-booting-bdcs-should-you-buy-the-dip-1393960960. By eliminating BDCs from the Russell 2000 Index, Russell index funds with disclosed expense ratios of from 20 to 30 basis points could reduce the expense ratio disclosed in their prospectus fee tables by 5 to 7 basis

in 2014. As a result of the "de-listing" from these indices, retail investors bore the brunt of falling BDC share prices and have continued to suffer from diminished analyst coverage and corporate governance oversight.

Requiring an acquiring fund to reflect BDC expenses in its prospectus fee table is misleading and contrary to the stated intent of the AFFE Rule.

With respect to BDCs, the AFFE requirements undermine the SEC's stated goals. Instead of providing "a better understanding of the actual costs of investing in a fund that invests in other funds," the existing AFFE requirements create the misperception that the acquiring fund's expenses are higher than they actually are. Such disclosure may even imply that the acquiring fund is actively engaged in operations of the acquired BDC rather than simply being a passive investor. Thus, requiring acquiring funds to add the management fees and operating expenses of BDC investments to their "total annual fund operating expenses" line item is at odds with the SEC's objective to provide investors with an improved understanding of the "actual" costs of investing in the acquiring fund.

The AFFE requirements distort the acquiring fund's disclosed expense ratio by suggesting that the BDC's expenses are operating expenses of the acquiring fund and, therefore, constitute additional costs paid by investors. However, acquiring fund investors pay BDC expenses no more than they pay the costs of inventory, raw materials or other expenses of any operating company in which the acquiring fund invests. In this regard, many large fund complexes have sought to alleviate this confusion in narrative disclosure in the acquiring fund's prospectus. For example, the Vanguard Explorer Fund discloses the following in its prospectus:

> The 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. The Acquired Fund Fees and Expenses are not included in a fund's financial statements, which provide a clearer picture of a fund's actual operating expenses.

Similarly, the Hartford Funds fund family includes the following disclosure in its prospectuses:

> Business development company expenses are similar to the expenses paid by any operating company held by a Fund. They are not direct costs paid by Fund shareholders and are not used to calculate a Fund's net asset value. They have no impact on the costs associated with Fund operations.

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points. Wells Fargo Securities Equity Research, *The 2Q18 BDC Scorecard* (Jan. 18, 2017) ("***2Q18 BDC Scorecard***"). The disclosed expense ratio reduction, of course, would have no effect on fund performance.

As discussed further below, most fund groups have nonetheless concluded that narrative disclosure – no matter how prominent – is unlikely to overcome the competitive disadvantage associated with an overstated fund expense ratio and, as a result, have generally sought to reduce or eliminate investments in underlying BDCs. As a result of this expense ratio distortion, the AFFE Rule, with respect to BDCs, has not produced "a better understanding of the actual costs of investing in a fund that invests in other funds" or "the means to compare directly the costs of investing in alternative funds of funds, or the costs of investing in a fund of funds to a more traditional fund," the two stated objectives of the AFFE Rule's adoption.[11]

The SEC has previously exempted a variety of investment vehicles from the definition of "acquired fund" and there is no discernible policy justification for denying BDCs similar treatment.

The SEC staff issued guidance in 2007 (in the form of answers to a series of frequently asked questions) that excluded from the definition of "acquired fund" under the AFFE rule "structured finance vehicles, collateralized debt obligations, or other entities *not traditionally considered pooled investment vehicles* (emphasis added)."[12] In this context, we believe BDCs should properly be regarded as operating companies, rather than funds. Short of this, we believe BDCs should, at least, be treated similar to the non-traditional pooled investment vehicles referenced in the staff's 2007 guidance because of the high degree of active management required to assemble and manage a portfolio of BDC investments.

In our view, a traditional pooled investment vehicle is one that generally acts as a *passive* owner of a basket of equity or debt securities or other financial instruments. The traditional pooled investment vehicle's success or failure is dictated by the business decisions of the portfolio companies' management teams, with which the vehicle's adviser has little or no involvement. In contrast, Congress has imposed on BDCs a statutory duty to make available significant managerial assistance to the businesses in which they invest.[13] Many BDCs provide portfolio companies with managerial and strategic financial expertise often by partnering with private equity sponsors to optimize a portfolio company's entire capital structure. BDCs and their advisers often participate in corporate governance, advise on strategic transactions and other key corporate decisions, and participate in the negotiation of sales and restructuring agreements.

Beyond providing managerial assistance to portfolio companies, many BDCs invest primarily in directly-originated loans. Sourcing, underwriting, negotiating and managing a portfolio of direct originations is a skill- and labor-intensive process that far more resembles the commercial lending operations of a bank than it resembles the assembly of a basket of exchange-traded or broadly-

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[11] *See, supra,* n 9.

[12] SEC Division of Investment Management, *Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses* (May 23, 2007), available at https://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm.

[13] *See* Section 2(a)(48) of the 1940 Act.

syndicated securities as does a traditional pooled investment vehicle. BDCs tend to be long-term investors that originate and hold investments to maturity rather than trading securities structured by other parties. It is because of the skill and labor required to source and underwrite deals, structure investments and manage a portfolio of bespoke investments in, generally, private companies that BDCs incur higher operating expenses than traditional mutual funds and ETFs. However, these expenses directly reduce a BDC's net asset value and, thus, are *already* accounted for in the returns that flow up to an acquiring fund. In this way, an acquiring fund's investment in a BDC is no different – and should be treated no differently – than an investment in a manufacturing firm, retailer or any other operating company in which the acquiring fund may invest.

In addition to the 2007 staff guidance that excluded collateralized debt obligations and other non-pooled investment vehicles, there is other precedent for exempting vehicles similar to BDCs from the scope of the AFFE rule. For example, BDCs are similar to real estate investment trusts ("***REIT***"), particularly credit REITs, which are not subject to the AFFE requirements. Similar to BDCs, REITs participate in the management or operation of a portfolio of real estate properties and the origination, structuring and active management of commercial mortgages. BDCs and REITs both distribute income to investors on a pass-through basis, share similar expense structures and are often targeted by similar investors. Notably, while REITs maintain operating expense profiles similar in nature to BDCs, REITs remain constituents of many of the major market indices, including indices sponsored by MSCI, S&P, and Russell.

The AFFE Rule harms retail investors by suppressing share prices, analyst coverage and corporate governance oversight of BDCs.

The decision by the index providers to drop BDCs as index constituents has had unfortunate consequences for the entire BDC ecosystem. One direct result is that passively-managed mutual funds and ETFs, which are designed to track the performance of these market indices, are now effectively prohibited from making investments in BDCs. The shift in assets from actively-managed to passively-managed funds has compounded this problem and drained a large portion of the pool of equity capital potentially available to BDCs. SEC Commissioner Robert J. Jackson Jr. observed that a company's inclusion in a prominent market index bestows significant economic benefits: "The decision to include a company in the S&P 500, for example, results in a reallocation of billions of dollars of investors' money." He also observed that the converse is true: "The average company added to the S&P 500 gains value; when it's removed, its share price drops as index funds sell their holdings."[14]

The removal of BDCs from the major indices also took away a key incentive for actively-managed mutual funds to continue investing in BDCs. Funds reasonably concluded that the costs of an

[14] The New York Times, *What's Really in Your Index Fund?*, (Feb. 18, 2019) (Robert J. Jackson Jr. and Steven Davidoff Solomon), available at https://www.nytimes.com/2019/02/18/opinion/index-fund.html.

overstated operating expense ratio (in terms of lost distribution opportunities) were too great.[15] In the past few years these concerns have intensified. The mutual fund market has experienced extreme cost competition due to the rise in popularity of ultra-low-cost index funds and ETFs[16] and structural changes spurred by the Department of Labor's 2016 investment advice fiduciary rule (which has since been vacated by the federal courts). A registered fund's independent research coverage, third-party rankings, and prospects of being accepted on many distribution platforms are substantially influenced by its overall operating expense ratio. In an environment where a single basis point can make a difference, it is little surprise that registered fund managers have largely shunned BDCs.

The systematic reduction in inflows from mutual funds and ETFs has reduced institutional ownership of BDC shares. By one measure, institutional ownership of BDC shares decreased by around 25% from 2013 to 2014, when BDCs were removed from the major indices. This dramatic shift in shareholder demographics has had a deleterious effect on BDC governance. Institutional shareholders are significantly more likely to participate in shareholder meetings than retail shareholders.[17] In fact, investment advisers – who may best understand the BDC industry– are subject to a fiduciary obligation to vote on BDC proposals in the best interests of the funds they manage. "Soft power," wielded through the promise of a large inflow or the threat of sales, also helps to promote industry best practices. A highly-regarded (former) research analyst in the BDC industry observed that: "Large institutional investors are often much better [than retail investors] about actively vetting corporate/board proposals."[18] A study conducted by the same analyst examining the voting patterns of BDCs with varying proportions of institutional ownership revealed that BDCs that suffered the largest decline in institutional ownership post-2014 were those that "likely need institutional policing the most" (*i.e.*, due to poor performance).[19] Of course, the benefits stemming from institutional investors' participation in BDC governance also inure to retail BDC shareholders.

The decline in inflows from mutual funds and ETFs also harms investors by artificially suppressing the liquidity and market depth of BDC shares. Notably, the average daily trading volume of BDC

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[15] 2Q18 BDC Scorecard.

[16] Several prominent fund sponsors including Vanguard, Fidelity and Schwab have recently engaged in a "race to zero" total expense ratio on a growing list of index funds and ETFs. *See, e.g.*, The Wall Street Journal, *Vanguard Ups the Ante in an ETF Race to Zero*, (Feb. 26, 2019), available at https://www.wsj.com/articles/vanguard-ups-the-ante-in-an-etf-race-to-zero-11551184467.

[17] Institutional shareholders' proxy vote participation rate was 91% in 2018, compared to 28% from retail shareholders. *See* Proxy Pulse, *2018 Proxy Season Review,*(October 2018) available at https://www.broadridge.com/_assets/pdf/broadridge-2018-proxy-season-review.pdf.

[18] 2Q18 BDC Scorecard, 18.

[19] 2Q18 BDC Scorecard, 18.

shares has plummeted by nearly 50% since 2014.[20] This reduction in market activity has also likely contributed to the low level of independent third-party research coverage for BDCs.

The AFFE Rule undermines Congressional intent to empower BDCs to finance American economic growth.

Congress created BDCs in 1980 after a decade marked by severe economic recession, stagflation and the savings and loan crisis. During that time, many traditional sources of capital for middle market business evaporated. In BDCs, Congress sought to prime economic growth by creating a new, capital-markets-based source of funding for small and private companies struggling to meet their capital needs.[21] In contrast, the AFFE Rule caused the purging of BDC shares from most major market indices and the funds that follow them, resulting in the 2014 selloff of BDC shares and the following five years of artificially suppressed demand.

Congress has taken note, recognizing that, by limiting inflows to BDCs, the AFFE Rule stifles capital formation in the U.S. middle markets. For example, in its reports on the 2017, 2018, and 2019 Financial Services and General Government Appropriations bills, the House Committee on Appropriations called on the SEC to take action to mitigate the "unintended, harmful consequences" imposed on BDCs by the AFFE disclosure requirements.[22] In addition, during a recent hearing of the Senate Banking, Housing, and Urban Affairs Committee entitled "Legislative Proposals on Capital Formation and Corporate Governance," Committee member and Pennsylvania Senator Pat Toomey observed that "BDCs have become a really important source of capital for small and growing companies" and that the "application of the SEC's [AFFE requirements] has a particularly adverse impact on BDCs . . . ."[23] Senator Toomey also called the AFFE requirements "inappropriate," noting that a BDC's market price already reflects its fees.[24] At the same hearing, a representative from the U.S. Chamber of Commerce indicated that the Chamber shared Senator Toomey's concerns and agreed that BDCs should be exempted from the AFFE requirements given their critical role in meeting the funding needs of many new and existing U.S. businesses, particularly since the 2008 financial crisis. Similarly, during a recent House Committee on Financial Services hearing, Congressmen Sherman and

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[20]The market cap weighted, average monthly trading volume in BDCs with greater than 100,000 shares fell from 1.2% of shares in 1Q 2014 to 0.6% in 3Q 2017. *See* 2Q18 BDC Scorecard, 18.

[21] *See, supra*, nn 3-4.

[22] H.R. Rep. No. 115-792, 115th Cong., 2d Sess. (2018); H.R. Rep. No. 115-234, 115th Cong., 1st Sess. (2017); H.R. Rep. No. 114-624 114th Cong. 2d Sess. (2016).

[23] *Legislative Proposals on Capital Formation and Corporate Governance*, Open Hearing before the S. Comm. on Banking, Housing, and Urban Affairs, 116th Cong., 1st Sess. (2019) (statement of Sen. Patrick J. Toomey, Member, S. Comm. on Banking, Housing, and Urban Affairs).

[24] *Id.*

Stivers also highlighted the negative impacts of the AFFE Rule on BDCs, noting, in particular, its "double counting" of BDC operating expenses which "are not additional expenses of the index fund, . . ."[25]

When the AFFE requirements were adopted in 2006, the SEC could not have anticipated the negative impact that the requirements would later have on BDCs. Notably, the "Cost-Benefit Analysis" section of the Funds of Funds Adopting Release revealed the SEC's belief that the AFFE requirements would *not* have "an adverse impact on capital formation."[26] This disconnect between the SEC's expectations and the reality that developed may be attributable to the fact that BDCs lacked a strong voice when the AFFE requirements were first considered. When the AFFE rule was proposed in 2003, there were only five significantly sized BDCs managing less than $5 billion in combined AUM. The relative youth and small size of the BDC industry in 2003 likely explains why the SEC may not have fully considered the extent of the impact of AFFE on BDCs and why the BDC industry failed to comment on the rule proposal.

Exempting BDCs from the definition of "acquired fund" will realign the AFFE Rule's application to BDCs with Congressional intent. Moreover, we believe it will promote growth in the number and size of BDCs and increase competition among them, translating to improved access to capital and better borrowing terms for portfolio companies. The Proposed Rule is an appropriate opportunity for the SEC to remediate the damaging effects the AFFE Rule has had on BDCs, BDC investors and the small and mid-size business that rely on them for capital.

The SEC should improve AFFE disclosure by excluding BDCs from the definition of "Acquired Fund."

As described more fully above, the AFFE Rule misleads investors and fails to achieve its stated purpose with respect to BDCs, has harmed and continues to harm retail investors in a variety of ways, and frustrates the primary capital formation purposes for which Congress created BDCs. Additionally, there is substantial precedent of the SEC excluding other similar categories of investment vehicles from the AFFE requirements. For these reasons, we strongly encourage the SEC to exempt BDCs from the definition of "acquired fund" under the Forms. It is critical to note that the heart of the AFFE problem for BDCs was the "de-listing" of BDCs from common indices that occurred in 2014. Unless a putative solution to the AFFE problem resolves the issues that led S&P, Russell and other index publishers to excise BDCs, it is not a solution at all. In our view, the simplest way to achieve this outcome is to fully exempt BDCs from the definition of "acquired fund" under the Forms.

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[25] *Oversight of the SEC's Division of Investment Management*, Open Hearing before the H. Comm. on Financial Services, Sub. Comm. on Capital Markets, Securities, and Investment, 115th Cong., 2nd Sess. (2018) (statements of Rep. Brad Sherman and Rep. Steve Stivers, Members, H. Comm. on Financial Services).

[26] Funds of Funds Adopting Release at 48.

While we recognize the concerns that prompted the SEC to adopt the AFFE Rule, we believe alternative disclosure requirements would similarly promote investor protection without causing the types of market distortions that have harmed BDCs, BDC investors and the small and medium-sized businesses that rely on them. Specifically, we would support pairing with the full exemption recommended above a disclosure requirement substantially as follows for acquiring fund investments in underlying BDCs:

- Require an acquiring fund to include in its prospectus narrative risk disclosure explaining that the total return of the acquiring fund's investment in the BDC will be net of any fees and expenses incurred by the acquired BDC.

II. FS Supports the existing provisions of the Proposed Rule

FS is pleased to support the Proposed Rule and applauds the Commission and SEC staff for designing a balanced and well-conceived proposal that stands to benefit the registered fund and BDC markets and their many participants.

In general, we believe that permitting registered investment companies and BDCs to exceed the limits imposed by Section 12(d)(1) of the 1940 Act will yield many of the same benefits for BDCs and their investors as we would expect from exempting BDCs from the AFFE Rule. Specifically, by lifting the Section 12(d)(1)(A)(i) restriction on a registered investment company or BDC acquiring more than three percent of the total outstanding voting stock of another investment company or BDC (the "***3% Rule***"), the Commission would remove a key regulatory impediment to greater institutional ownership of BDCs. With greater institutional ownership comes many benefits for BDCs, BDC investors, and the middle market businesses in which BDCs invest:

- For BDCs, we believe increased demand from institutional investors would support BDC share prices, trading volume and the depth and liquidity of the BDC market.

- For BDC investors, we believe increased institutional ownership would promote better corporate governance and management oversight as well as more insightful analysis of the BDC market through increased third-party analyst coverage and research reports.

- For BDC portfolio companies, we believe greater demand from institutional investors would support capital formation while decreasing BDCs' cost of capital, meaning that BDCs could invest more, and on better terms, in the portfolio companies that rely on them.

Of course, many of these benefits will remain unrealized if the Commission does not also address the harmful effects of the AFFE Rule together with its proposed revisions to the 3% Rule – raising the regulatory cap on investment company ownership of BDCs is meaningless if investment companies continue to shun BDCs altogether to avoid artificially inflating their expense ratios as a result of the

AFFE Rule. Therefore, it is imperative that the AFFE Rule and the 3% Rule be addressed in tandem in any final rule resulting from the Proposed Rule.

FS supports the conditions built into the Proposed Rule and believes they represent a sensible balance of competing interests. First and foremost, we strongly support the exclusion of private funds and unregistered investment companies from eligibility under the Proposed Rule. The SEC rightly identified that permitting private and foreign funds to build up large positions in registered investment companies and BDCs was an area ripe for abuse and that extending these new benefits to funds that already escape most requirements under the 1940 Act is neither needed nor balanced. Subject to some minor recommendations for improvement, we also generally support the other conditions built into the Proposed Rule, including the voting provisions, redemption limits and restrictions on complex structures, which we address in the following section.

III. FS offers the following recommendations to improve the Proposed Rule

Voting Provisions

As described in the Proposing Release, the Proposed Rule would require an acquiring fund that exceeds the 3% Rule to vote its shares of the acquired fund in one of two ways: "pass-through voting," in which the acquiring fund must vote its shares according to the proxy instructions of its beneficial owners, or "mirror voting," in which the acquiring fund must vote its shares in the same proportion as the vote of all other holders of the acquired fund.

We agree that voting controls are necessary for acquiring funds that exceed the 3% Rule, but we are concerned that pass-through voting may yet be susceptible to manipulation. Accordingly, we would prefer mirror voting to be the sole voting method for acquiring funds under the Proposed Rule.

Redemption Limits

FS generally supports proposed rule 12d1-4(b)(2)'s limitation on an acquiring fund that acquires more than 3% of an acquired fund's outstanding shares from redeeming or seeking to redeem more than 3% of the acquired fund's total outstanding shares in any 30-day period. However, we believe the policy objective underlying this limitation does not hold with respect to affiliated funds. Accordingly, we would support a limited exemption from the Proposed Rule's 30-day redemption limit for transactions between affiliated funds.

The proposed redemption limit may inadvertently impede legitimate business reasons (*i.e.,* reasons unrelated to the exertion of influence or control over an acquired fund) that an acquiring fund may need to liquidate a position in excess of the 3%-in-30-day limit. Such reasons may include routine fund rebalancing or the maturation of target date funds. FS would support a limited exemption to the Proposed Rule's 30-day redemption limit for legitimate, routine business purposes unrelated to the exertion of influence or control over an acquired fund.

Schemes to Evade the 3% Cap

In assessing an acquiring fund's control over an acquired fund, the Proposed Rule would aggregate the acquiring fund's investment with those of its advisory group to "prevent a fund or adviser from circumventing the control condition by investing in an acquired fund through multiple controlled entities, e.g., other funds in the fund complex."[27] While we support this objective, we are concerned that applying this type of aggregation only to registered funds does not go far enough to prevent similar schemes to evade the statutory limits. For example, we have heard of instances whereby certain actors seek to evade the current 3% Rule by forming numerous *private* funds under common control that each acquire 3% of the outstanding voting stock of a target fund. While we do not understand the Proposed Rule to make these types of schemes easier, we believe this rulemaking presents an excellent opportunity for the Commission to more explicitly prohibit such abuses, and we urge the Commission to take such action.

Restrictions on Complex Structures

The three-tiered fund of funds limitation condition contained in the Proposed Rule should be revised to either eliminate the limitation as it applies to the ability of an acquired BDC to acquire a Section 3(c)(1) or Section 3(c)(7) fund or otherwise include an additional exception thereto that takes into account certain common market practices relating to investments by BDCs in private funds.

Many BDCs seek to invest alongside private equity sponsors in portfolio companies to avail themselves of certain benefits, such as obtaining an additional layer of due diligence and monitoring capabilities. Private equity sponsors also provide the portfolio companies of BDCs with strategic guidance, an additional potential source of capital and additional operational expertise (in addition to any managerial assistance from the BDC). Given that BDCs seek to build long-term relationships with those private equity sponsors that also invest in the small and mid-sized companies BDCs target, it is not uncommon for BDCs to be offered from time to time the opportunity to invest in the private funds of these private equity sponsors in amounts that exceeded the 3% Rule.

Similarly, many BDCs form "joint venture funds"[28] with third-parties to, among other reasons, take advantage of attractive long-term financing and improve portfolio credit quality by investing in more conservative first lien loans. Joint ventures also allow BDCs to form mutually beneficially investing

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[27] Proposing Release at 33.

[28] A "joint venture fund" is a fund (i) that would be an investment company under Section 3(a) of the 1940 Act but for the exclusions from that definition provided for in Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, (ii) that is treated as unconsolidated portfolio company of a BDC and (iii) in which all portfolio decisions, and generally all other decisions in respect thereof, must be approved by an investment committee consisting of representatives of the BDC and the unaffiliated joint venture partner in the fund (with approval from a representative of each required).

relationships with other large institutional investors, including insurance companies, pension funds and other BDCs.[29]

Given the importance of these arrangements to BDCs, we believe it is appropriate to either eliminate the three-tiered fund of funds limitation condition in the Proposed Rule as it applies to the ability of an acquired BDC to acquire private funds or otherwise to include an additional exception thereto that takes into account the common market practice of BDCs investing in private funds in the circumstances described above.

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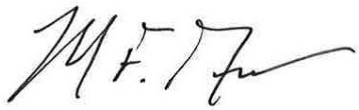
FS thanks the Commission for crafting a thoughtful and well-balanced Proposed Rule and for seeking public input on the AFFE Rule. We are confident that by exempting BDCs from the AFFE requirements and with the few recommended improvements outlined above, the Final Rule can unlock institutional investment in BDCs to the benefit of the entire BDC ecosystem.

Please contact Seth Hertlein, Executive Director of Public Policy and Assistant General Counsel, at [redacted] or [redacted] if we can provide additional assistance.

Sincerely,



Michael F. Gerber
Senior Managing Director, Corporate Affairs
FS Investments

[29] For example, FS/KKR Advisor, LLC is a joint venture partnership between FS Investments and KKR Credit Advisors (US) LLC which advises FS KKR Capital Corp.