Dear Chairman Clayton:

We write today to express our concern over the Securities and Exchange Commission’s (SEC) application of the Acquired Fund Fees and Expenses (AFFE) disclosure to business development companies (BDCs) (the “AFFE disclosure requirements”). On December 19, 2018, the SEC issued a release that included a request for comments on the existing AFFE disclosure requirements, File No. S7-27. As original sponsors and supporters of the Small Business Credit Availability Act of 2018, we have a strong interest in the BDC market and the thousands of small and middle-market U.S. businesses supported by BDC investment. These small and middle-market businesses are vital to promoting job formation and growth of the U.S. economy as a whole. While we very much support the SEC’s goal to create a consistent and efficient regulatory regime in this space, we are concerned that the AFFE disclosure requirement as applied to BDCs has a harmful impact without a reciprocal consumer or public policy interest, which, in turn, hurts the small and midsize businesses that rely on BDCs for capital. We therefore urge the SEC to tailor the AFFE disclosure requirements to limit the adverse and unintended impact that AFFE has on BDCs.

**BDCs are Distinct from Registered Investment Companies and Should be Treated Differently with Respect to AFFE Disclosure**

At the time BDCs were created by Congress in 1980, registered investment companies had existed for forty years. Registered investment companies typically invest in publicly-traded companies. Congress recognized a need to make capital available to smaller, non-traded businesses and passed legislation to create a new form of investment company with a particular focus. Accordingly, BDCs were intended by Congress to be distinct from registered investment companies and were given a specific Congressional mandate: to make capital available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing. BDCs are structured as closed-end funds and elect to be regulated under the “business development company” provisions of the Investment Company Act of 1940, as amended (the “1940 Act”). Unlike registered investment companies, which generally have the ability to tailor their investment strategies to various asset classes, BDCs are required to focus their investment strategy. Specifically, the 1940 Act requires a BDC to invest 70% of their assets in privately-owned U.S. operating companies or public U.S. companies with a market capitalization of less than $250 million.\(^1\) Further, BDCs are statutorily required to make available managerial assistance to the companies in which they invest.

Due to their unique statutory mandate, BDC costs and expenses significantly differ from those of registered investment companies. As discussed above, BDCs generally invest in publicly-traded securities less frequently. Instead, BDCs focus their investments in small and middle-market companies, many of which are private. Such investments require a more robust infrastructure that includes a greater emphasis on deal sourcing and due diligence than investing in the securities of public companies.

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Further, unlike purchasing publicly-traded securities, BDCs often are required to negotiate and structure the terms of their investments. After a BDC has made an investment, it must have the appropriate resources to monitor and manage its portfolio, which often requires direct contact with companies in which it invests. Finally, should a BDC's portfolio company accept the managerial assistance it offers, the BDC, like an operating company, must further allocate resources to the ongoing management of such company. Other closed-end funds, on the other hand, generally do not have to bear these costs and expenses and consequently have lower operating expenses. Finally, Congress empowered BDCs with greater flexibility to use leverage to fulfill their unique statutory mandate, meaning that, like operating companies, BDCs often have greater interest expense than registered investment companies which further magnifies the operational cost difference between them.

In applying the AFFE disclosure requirement to regulated funds, but not to operating companies, the SEC failed to recognize the important distinctions Congress drew between registered investment companies and BDCs and the special role BDCs were intended to serve in our capital markets and economy. With respect to AFFE disclosure, BDCs should be treated comparably to operating companies and thus be excluded from the AFFE disclosure line item.

**AFFE Produces Misleading and Inaccurate Information to Investors and Produces Unfair and Deleterious Effects on BDCs**

In the adopting release, the SEC stated that that the AFFE disclosure requirements are intended to benefit investors by improving shareholder access to information regarding indirect costs resulting from a fund's investment in another fund. In releasing its final rule in 2006, the SEC stated that the AFFE disclosure requirement would not have an adverse impact on capital formation. However, that has not proven to be the case with respect to BDCs.

Under the AFFE disclosure requirements, regulated funds include a separate line item for “Acquired Fund Fees and Expenses” in the “Fees and Expenses” table in registration statements. The separate AFFE line item must include the regulated fund’s pro rata share of the “acquired fund’s” expenses. The AFFE expense line item is added to the acquiring fund’s actual operating expenses and, as a result, increases the “total annual fund operating expenses” line item – the fund’s expense ratio.

However, the AFFE line item is not reflective of a true fund operating expense of the acquiring fund because it does not represent a direct cost paid by the fund. AFFE disclosure requirements have no impact on the financial statements of the acquiring fund. Instead, AFFE acts as a deterrent to investors who refer to the fund’s registration statement without reviewing the financial statements. Therefore, the inclusion of BDCs, with their relatively high operating expenses, in the calculation of AFFE unfairly harms BDCs more than registered investment companies.

Since the promulgation of the AFFE rule, investments in BDCs have sharply declined. Additionally, beginning in 2014, major index publishers Russell, S&P and MSCI “de-indexed” BDCs. In announcing its decision to de-index BDCs, Russell cited the “distortive impact” of AFFE on index fund expense...
During the 2014 de-indexing, BDC share prices plunged as funds that track or benchmark to indices dumped their shares. Investors bore the brunt of this selloff. In 2014 alone, institutional ownership of BDC shares fell by 25%, from 42.2% in 4Q13 to 31.7% in 4Q14 and has continued to fall to around 24% today—a nearly 50% reduction since the end of 2013. As institutional investors left the space, much of the vitality of the BDC market left with them—average daily trading volume of BDC shares fell by 50% between 2014 and 2017.

The disruption of AFFE not only affected institutional investors but also affected retail investors. BDCs are attractive to retail investors because they provide access to an asset class typically only accessible to institutional and wealthy investors that can invest in private funds. The significant decline of institutional ownership negatively affected, and continues to affect, retail shareholders. Further, because passive investment vehicles that track major index publishers no longer invest in BDCs, the market depth and liquidity for BDC shares has sharply declined. This has resulted in less independent, third party coverage of the market. Though the SEC’s stated goal of AFFE disclosure was to provide investors with more information, it has inadvertently decreased investor access to information. Further, reducing institutional ownership has weakened corporate governance for retail shareholders, as greater institutional ownership results in a more engaged shareholder base.

Not only is the application of AFFE disclosure requirements to BDCs inconsistent with the statutory mandate for BDCs, it is also contrary to the SEC’s stated objectives for the AFFE disclosure. We believe that the SEC should take steps to exclude BDCs from the AFFE disclosure requirements and understand that it has the authority to do so. In order to restore congressional intent and correct the unintended consequences that threaten BDCs as a vehicle for allocating capital to small and mid-sized businesses, we encourage you to use your authority to tailor the AFFE rules to better align with the unique nature of BDCs and to ameliorate the harm done to BDCs and, in turn, to retail investors and Main Street American businesses.

Sincerely,

Gwen Moore  
Member of Congress

Steve Stivers  
Member of Congress

Brad Sherman  
Member of Congress

Bill Huizenga  
Member of Congress

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2 Wells Fargo, 2Q18 BDC Scorecard.
3 Raymond James, 11/8/19 BDC Weekly Insight.
4 Wells Fargo, 2Q18 BDC Scorecard.
5 See, e.g., Bock, O'Shea and Mazzoli, New SEC Leadership Announced and Hopefully A Fresh Take on an Old Rule, Equity Research (Wells Fargo Securities, LLC) (Sept. 7, 2017).
6 Wells Fargo 1Q17 BDC Scorecard ("[L]ower institutional ownership led to a much less engaged shareholder base, which, in turn, led to much less corporate governance on behalf of retail investors. . . . Large institutional investors are often much better about actively vetting corporate/board proposals").