



January 6, 2005

Mr. Jonathan G. Katz
Security and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549

RE file number S7-37-04

Dear Mr. Katz:

We would like to go on record supporting the rule changes proposed to help define an eligible portfolio company for Business Development Companies (“BDCs”).

I have been running BDCs since the beginning of the BDC era in 1980’s and worked on the legislation that created BDCs in 1979-80. The 1980 Act is flawed in a number of places and it is nice to see the SEC is seeking to correct some of the flaws.

Small Business: The concept behind the 1980 Act was to have an investment vehicle similar to closed-end funds that would invest in small business. The problem was then, and is today, is that no one can agree on the definition of a small business. So the concept of an eligible portfolio company (“EPC”) came into being as a way to define what a BDCs could invest in. The desire on the part of the drafting team was to create a term that would exclude large public companies but include everything else. The idea of using the margin requirements under Reg. T of the Federal Reserve Board (“Fed”) was a simple one that gave the Fed the power to define EPT. In hindsight, this was a mistake because at the time no one dreamed that the NYSE or NASDAQ would grow and have so many listing of smaller companies. When I served on the listing and hearing committee of NASDAQ we attempted to reduce the number but it just kept expanding. Nor did the drafters of the 1980 Act think that the stuffy old Fed would become so liberal with the definition for which securities were marginable for bank loans.

In reviewing the definition of securities we found that Reg. T refers to the 1934 Act not the 1940 Act. This is notable because the definition of security for the 1934 Act has been defined very narrowly by the U.S. Supreme Court. A security the Court says has to meet a family of tests in order to be considered as security. And since most of the securities (invested in by BDCs) does not meet the test of securities as defined in the 1934 Act by the Court, it can easily be argued that the securities that BDCs invest in are not securities at all. The one exception is of course, small public companies listed on NASDAQ and NYSE.

The SEC has arrived at a definition, while very conservative, that definition does a better job than the original drafters of the 1980 Act and for that reason alone the proposed rule should be adopted. Although some have suggested a market capitalization standard would be better, that seems to be more trouble than it is worth. How would the SEC ever arrive at a number that would define small and once the SEC set the number, how would the number be adjusted for inflation and the market's irrational exuberance? We too would reject a market capitalization standard as being too volatile.

Higher risk: We see no reason to believe that the SEC proposal would encourage BDC operators to invest in riskier investments. The door is open for all BDC's to invest 30 percent of their capital into companies that are not EPCs. It has been that way since 1980 and from our analysis of the industry, the 30% rule has not encouraged BDC's to invest 30% of their portfolio into riskier investments. To now assume that the SEC proposed rule will encourage riskier investments is not good logic.

DIP financing: Opening the rules so that BDCs can invest more than 30% of their assets in DIP financing is also a good idea. However we doubt that it will increase the flow of BDC assets into DIP financing. There are only a few BDCs doing any DIP financing today and we doubt the flexibility set out in the SEC proposal will increase the flow but it is a nice expansion. DIP financing is run by some very interesting asset-based lenders. Expanding the source of such financing will help more small business exit from bankruptcy.

Still one problem: Our only criticism of the proposed new SEC rule is that it is too conservative. The old definition of EPC as the drafters designed it in 1980, included many small public companies that will now remain excluded by the SEC's definition. Clearly the drafters of the 1980 Act desired to include small public companies since they did just that. Using the new definition established by the SEC will still exclude thousands of small public companies that would be included in EPC using the drafter's definition. It would be nice if the SEC would define EPC to include small public companies as was the intent of the original drafters of the 1980 Act. Most of the small cap public companies cannot attract investors from the open-end funds because they lack liquidity and when the closed-end funds invest in the small public companies, the closed-end funds own shares usually go to a discount to reflect the lack of liquidity. Opening up the definition of EPC to include more small public companies would help the flow of capital to these forgotten businesses which was the intent of the 1980 Act. And since 80% of all the new jobs are created by small companies (both public and not public) inclusion of small public companies in the definition of EPC would achieve what the 1980 Act set out to do.

Added Test for EPC: We would suggest that the SEC use a test of EPC of public companies as ones that have a net worth of less than \$100 million and revenue of less than \$500 million for the prior twelve months. This would be a simple test that one could see on the audited financial statements of the small public company. We suggest that the SEC give good consideration of this very easy test in order to bring back the original intent of the 1980 Act to have BDCs finance small public companies.

Even if the proposed SEC rule is too conservative, it should be put into effect. While we believe that the original intent of the drafters of the 1980 Act was to include small public companies, a "partial loaf of bread" to the desperate is better than nothing.

And the small business world is desperate for more capital. We applaud the SEC's initiative in seeking to change the definition, we hope the SEC will consider a complete solution to the definition by including small public companies in the definition of EPC.

Sincerely,

David Gladstone, Chairman
Gladstone Capital Corp (NASDAQ: GLAD)