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Congress of the United States

Washington, DC 20515

January 5, 2005

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OFFICE OF THE SECRETARY

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

Re: File Number S7-37-04

Dear Mr. Katz:

We request that the attached letter be submitted as our comments on the Commission's proposed rule regarding the definition of eligible portfolio company under the Investment Company Act of 1940 (Release No. IC-26647; File No. S7-37-04). Thank you.

Sincerely,

Sue Kelly
Member of Congress

Nydia Velázquez
Member of Congress

Enclosure

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Washington, DC 20515

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Chairman William H. Donaldson
U.S. Securities & Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Donaldson:

We write regarding the SEC's proposed rule (Release No. IC-26647; File No. S7-37-04) to change the definition of "eligible portfolio company" and the investment activities of business development companies (BDCs).

We welcome the Commission's interest in modernizing the definition of eligible portfolio company. In 2001, the Commission received recommendations during its annual "SEC Government-Business Forum on Small Business Capital Formation" to modernize the definition.[1] The definition has been outdated since at least 1998, when the Federal Reserve Board made significant changes to its margin rules. More recently, we sponsored legislation in the 107th and 108th Congresses to modernize the definition. We oppose the rule as drafted because it fails to address the problems caused by the change in the margin rule definition by the Federal Reserve Board.

As proposed, the rule is: (1) selective in its description of legislative history, creating a misleading impression and reflecting a misunderstanding of Congressional intent; (2) inconsistent with the authority Congress granted the Commission to modify and expand the definition of eligible portfolio company; (3) inconsistent with other pending and approved rulemakings; (4) not supported by meaningful economic data and analysis; and (5) fails to properly protect the rights and interests of the shareholders of business development companies.

As the Commission's proposed rule recognizes, the statutory definition is tied to the Federal Reserve's margin rules, which have changed significantly since 1980, thus reducing the number of public companies that qualify as eligible BDC investments. Therefore, in the 108th Congress, we introduced, and the House unanimously passed, H.R. 3170, the Increased Access for Growing Business Act. This legislation was intended to modernize the definition of "eligible portfolio company" and to help more small and growing companies access the capital they need to expand and add jobs. It would replace the law's reliance on the Federal Reserve's margin rules with a market capitalization standard for purposes of determining if the entity in which the BDC will invest is a qualified portfolio company. At least 70% of a BDC's investments must be in eligible portfolio company assets.

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[1] U.S. Securities and Exchange Commission, "SEC & Small Business: Final Report of the SEC Government-Business Forum on Small Business Capital Formation," http://www.sec.gov/info/smallbus/gbfor19.htm, May 2001.

These recent efforts were an outgrowth of our work on this issue during the 107^{th} Congress. The House Financial Services Subcommittee on Oversight and Investigations received testimony on June 26, 2001, from the BDC industry on the need to modernize the BDC regulatory framework. At that time the industry testified that they had approached the Commission staff on the issue of the scope of "eligible portfolio company," but they were encouraged to seek a legislative solution. On July 26, 2002, we introduced H.R. 5258, a bill that replaced the margin rule requirement with a market capitalization requirement. That legislation would have made any company with less than $1 billion in market capitalization an eligible portfolio company. The Commission staff was approached for technical assistance, and the Committee was advised that the market capitalization level was likely too high. The staff of the Division of Investment Management offered to work with our staff to develop a market capitalization standard that would more closely reflect our intention to restore the number of public companies that could qualify as eligible portfolio companies.

Our staff requested data from the Commission staff and the BDC industry to support a market capitalization level that would reflect the number and percentage of public companies that qualified as eligible portfolio companies in 1980 when Congress first established these special closed-end funds. We received significant third-party data from the BDC industry showing every public company's market capitalization, company-by-company. That data supported the use of a $250 million market capitalization standard to qualify approximately 8,000, or about two-thirds of all publicly traded companies, as possible qualified portfolio companies. The Commission staff failed after repeated requests to provide similar data, although the staff claimed that a $250 million market capitalization standard would cover a larger percentage than 66% of all public companies. We have continued to request supporting data from the Commission staff but have received no such data.

The proposed rule is nearly identical to a Commission staff proposal that was shared with certain senior Committee staff just prior to House action on H.R. 3170 with the suggestion that the text of H.R. 3170 should be amended to comport with the thrust of what is now a proposed rulemaking. The Committee rejected the approach, and the House of Representatives unanimously approved an alternative approach by passing H.R.3170 as an effort to help public capital reach smaller and growing public companies. We continue to believe that the approach taken in the proposed rulemaking fails to serve the needs of small and growing businesses, and reflects a misunderstanding of the capital needs of many publicly traded companies.

When we began our legislative efforts on this issue, we understood that the Commission staff and the BDC industry generally understood that all privately traded companies and all public companies traded on the Pink Sheets and over-the-counter bulletin board listings were eligible portfolio companies. However, after receiving questions from one or more potential new BDC registrants the Commission staff has raised the possibility that non-public companies that have issued debt securities may no longer be qualify as eligible portfolio companies. The proposed rule does address the very recent staff concern, and returns non-public companies to the group of entities which the industry and Commission staff have traditionally treated as qualifying eligible portfolio companies. But the rule totally fails to reestablish the majority of publicly traded companies that originally qualified as eligible portfolio companies, which was the purpose of our legislative effort.

Modernizing the definition of an eligible portfolio company offers an opportunity to help foster capital formation for small and growing businesses. However, the proposed rule incorrectly presumes that most publicly traded companies have no problems accessing the public capital markets. Instead, the proposed rule suggests that business development companies should refocus their resources on distressed companies – especially debtor-in-possession financing. This failure to focus on the capital access problems of small and growing public companies reflects a misreading of the legislative history, which we will discuss further below.

We hope that the Commission will amend its proposal to be consistent with Congressional mandates and the legislative history. We urge the Commission to either amend its rule consistent with the provisions of H.R. 3170, or support House and Senate action to legislate such a solution.

1. **The proposal is selective in its description of legislative history, creating a misleading understanding of Congressional intent.**

The proposal ignores the legislative history of the Small Business Investment Incentive Act of 1980 ("SBIIA") with respect to what qualifies as an eligible portfolio company investment. The proposed rule would significantly reduce the number of companies to which BDCs would be able to extend capital than the number Congress originally intended. Specifically, the legislative history of the SBIIA of 1980 set forth Congress' clear intent:

> "**The pool of such eligible portfolio companies under the Bill is very broad**.... It is estimated there are about 12,000 publicly held operating companies; the definition of 'eligible portfolio company' would include about two-thirds, or 8,000, of those companies, plus all privately-held companies. In addition, the Commission is given rule-making authority to expand the class of eligible portfolio companies..."[2] (emphasis added).

We are deeply troubled that the proposed rule does not mention this portion of the legislative history. This history was shared repeatedly with the Commission's staff. In fact, the legislative history of Congress was communicated during the debate and consideration of H.R. 3170, the Increased Access for Growing Business Act, on April 28, 2004. Congresswoman Kelly restated the original intent of Congress by saying, "In 1980, BDCs were able to invest in approximately 66 percent of the 12,000 publicly held operating companies."[3] Congresswoman Velazquez added, "In 1980, when BDCs were first authorized by Congress, about two-thirds of all publicly held companies were eligible for BDC investment."[4]

Based upon the legislative history of the 1980 Act, the Committee staff requests for data, and the floor debate of H.R. 3170, the Commission staff should have been fully aware of Congressional intent that the pool of eligible investments include a supermajority of all public companies, and the definition be broad in scope. Instead, the proposal effectively eliminates the possibility of publicly traded companies listed on the NASDAQ or exchanges from qualifying as 70% basket investments.

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[2] House of Representatives Report No. 1341, 96th Congress, 2d Session, p. 23 (1980), ("House Report").
[3] Congressional Record, 108th Congress, April 28, 2004, H2424.
[4] Ibid.

We see no data or analysis in the proposed rule that suggests any attempt to ensure that the proposed rule would cover about 8,000 public companies as eligible portfolio companies as originally intended by Congress. Nor do we see any attempt in the proposal to ensure that the pool of eligible portfolio companies is "very broad," as envisioned by the Congress. To the contrary, the proposed rule states that "listing on an Exchange or on NASDAQ generally provides an issuer with visibility, marketability, third party established valuations and liquidity, all of which aid in capital formation." The proposed rule then concludes that "we generally believe that most issuers that are able to list their securities on an Exchange or on NASDAQ have access to the public capital markets." There is absolutely no supporting analysis to these statements or this conclusion.

The proposed rule states that companies that trade on the Pink Sheets or over-the-counter bulletin board have few analysts covering them, making it difficult for investors to obtain much information about them. We believe the final rule should carefully examine the number of analysts and institutional investors in companies with market capitalizations of $250 million and less. We believe the analysis will show that these companies have not accessed the public capital markets for significant capital, have little analyst coverage, and less institutional investors demonstrating that these public companies indeed have capital access problems.

According to Standard and Poor's, a small publicly traded company is above this $250 market capitalization threshold. Its S&P SmallCap 600 index of small-cap stocks currently requires a company to have a market capitalization between $300 million and $1 billion before it can be included as part of the index.[5] This demonstrates that the maximum $250 million market capitalization threshold for "eligible portfolio companies," as proposed in H.R. 3170, may be on the low end of what is widely considered to be a small publicly traded company.

2. **The proposal fails to comport with the authority Congress gave the Commission to modify and expand the definition of eligible portfolio companies.**

Section 2(a)(46)(C)(iv) of the Investment Company Act authorizes the SEC to add other categories of issuers that "meet[s] such other criteria as the Commission may, by rule, establish as consistent with the public interest, the protection of investors, and the purposes fairly intended by the policy and provisions of this title." This clearly provides the SEC with authority to modify the definition of eligible portfolio company to meet the policy goals of the Act, namely increasing the flow of capital to small businesses.

Furthermore, the Congress provided the Commission with authority to expand, not restrict, the definition of eligible portfolio company. The proposal fails to recognize that the Congress gave explicit authority for the Commission to "expand the class of eligible portfolio companies."[6] The legislative history states that "the Committee expects that the Commission would institute proceedings to consider whether the definition of eligible portfolio company can be expanded, consistent with the purpose of the legislation, to increase the flow of capital to small, developing businesses or financially troubled businesses."[7] The proposed rule does not expand the class

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[5] Standard & Poor's, http://www2.standardandpoors.com/spf/pdf/index/600brochure.pdf
[6] House Report, p. 23.
[7] House Report, p. 31.

from that which existed in 1980. If adopted, the proposed rule does the contrary – it narrows by thousands the number of companies that qualify for treatment as an eligible portfolio company.

It is very troubling that the proposed rule completely disregards two categories of eligible portfolio company investments – small and developing companies. The legislative history explains that BDCs are intended to provide "capital and assistance to small developing or financially troubled businesses that are seeking to expand…"[8] Nowhere in the rule is there a discussion or analysis of how the definition would facilitate BDC investments in small or developing companies. It instead focuses almost exclusively on those companies that are financially troubled, as discussed more fully below.

The legislative history provides additional factors that the SEC may consider in its consideration of whether the definition of eligible portfolio company can be expanded. It cites factors such as the "size of such companies, the extent of their public ownership, and their operating history as going concerns and public companies."[9] In using a definition based upon whether a company's stock trades on a certain market, the SEC ignores factors such as size, which Congress directed the SEC to consider. The legislative history, by identifying size as a factor to base any expansion of definition, instead logically infers that the utilization of a market capitalization standard would be an entirely appropriate measure.

In 2004, the SEC staff for the first time raised concerns that the margin rule definition may disqualify any non-publicly traded company that had ever issued a debt security. After more than two decades of practice by the industry and the Commission of treating all non-publicly traded companies as eligible portfolio companies, without any change in Federal Reserve or Commission rules the staff requested information from every BDC registrant as to the scope of the margin rules and the BDC community's practice of disregarding debt issuance in determining eligibility.

As a result, at the request of Commission staff, BDCs are now including in their financial reports disclosures about the uncertainty of the scope of the definition of eligible portfolio companies. For example, the following is excerpted from Apollo Investment Corporation's 10-Q (ending September 30, 2004).

> "Amendments promulgated in 1998 by the Board of Governors of the Federal Reserve System to Regulation T… expanded the definition of marginable security to include any non-equity security. These amendments have raised questions as to whether a private company that has outstanding debt securities would qualify as an eligible portfolio company."

With such a restrictive definition, BDCs are limited to very few potential investments (only those private companies with no debt securities), and public companies traded on the Pink Sheets and bulletin board. The proposed rule addressed this newly created problem by the staff, but does nothing "to expand the class of eligible portfolio companies" as required under the Commission's authority.

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[8] House Report, p. 23.
[9] House Report, p. 31.

3. The proposal is inconsistent with other pending and approved SEC rulemakings.

In its brief reference and subsequent dismissal of a market capitalization standard for determining companies qualifying for the 70% basket, the Commission fails to mention another SEC rulemaking proposal, the Securities Offering Reform [File Number S7-38-04]. The Securities Offering Reform proposal provides a rigorous analysis of determining whether an issuer has a demonstrated market following. Based upon such analysis, it uses a market capitalization standard, with a $700 million threshold for those issuers that are well-followed. In establishing the $700 million threshold, it analyses factors such as analyst coverage, institutional ownership, and trading volume to distinguish between those issuers with or without a demonstrated market following.

The Commission has used market capitalization measures in other rules, so it is highly questionable why such a measure is not acceptable for purposes of the BDC rule. One recent example of a rule using market cap is the SEC's postponement of the filing date for internal control reports for small companies with less than $700 million in public equity float.[10] In the implementing Sarbanes-Oxley Act rules, the SEC gave companies with a market capitalization of less than $75 million additional time to comply with the internal control report. Footnote 35 of the proposal also cites several other instances where market capitalization is used, in these cases to determine small business issuer classifications for purposes of compliance with the Regulatory Flexibility Act and Regulation S-B. Certain market indexes, such as the S&P Small Cap 600 Index and the Russell 2000® Index, also use market capitalization standards to determine eligibility of stocks for inclusion in such indexes.

Precedent, including the above cited pending rule making, clearly exists for using a market capitalization standard for Commission rule makings.

4. The proposal is not supported by meaningful economic data and analysis.

Congress gave the Commission authority to "gather, analyze, and make available to the public, information with respect to the capital formation needs, and the problems and costs involved with new, small, medium-sized, and independent businesses."[11] However, no such information was cited in the proposed rule.

As discussed above, the Commission fails to give adequate support for its decision to forgo using a market capitalization standard for determining the threshold for the 70% basket. The Commission provides no empirical analysis explaining why it believes a market capitalization approach is flawed.

The Commission also fails to provide empirical justification supporting a definition based on trading platform. It does not provide analysis or justification for the policy prohibiting a BDC from investing in a company listed on an Exchange or NASDAQ except in the case that the company receives a de-listing notice **and** it does not meet the initial listing requirements for any

[10] Securities and Exchange Commission, Release Nos. 33-8501; 34-50624; IC-26649 International Series Release No. 1282 File No. S7-38-04, (November 17, 2004) 69 FR 67397 ("Securities Offering Reform").

[11] 15 USC 80c

other Exchange or NASDAQ. A requirement that a company receiving de-listing notice search other markets to ensure that it does not meet other listing standards will be costly to BDCs and their shareholders. In addition, the rule will force the company in need of financing to wait to receive capital at the very time it is in the most need – when it receives a de-listing notice. This is yet another economic cost that the Commission fails to measure.

The proposal asserts that using a market capitalization approach "could result in some registered investment companies electing BDC status to take advantage of the less restrictive provisions of the Investment Company Act generally applicable to BDCs." It is unclear why the Commission believes this would be the result. Although some legal provisions provide BDCs with more flexibility to invest in small businesses, BDCs are subject to many regulations and laws that do not apply to other registered investment companies. For example, BDCs are publicly traded companies and must therefore comply with all of the financial reporting disclosures, including the Sarbanes-Oxley Act requirements, not applicable to mutual funds. In addition, even with a market capitalization standard, the scope of BDC investments in publicly-traded companies would be much narrower than that permitted for mutual funds, including other closed-end funds. Therefore, we question what effective advantage a registered investment company would have by electing to become a BDC.

In addition, the Committee requested and received data from the Division of Corporate Finance analyzing the factors used in developing the definition of "seasoned issuers." The data was broken down into various market capitalization categories. We believe this data supports the notion that companies with a $300 million market capitalization and less need assistance in accessing capital.[12]

Using the most recent 2003 data supplied by the SEC:

- Companies with market capitalizations below $300 million have no more than a median of 2 sell-side analysts (no more than 1 analyst for those below $200 million) compared to at least 10 analysts for companies above $700 million market cap. The SEC's proposed BDC rule (File No. S7-37-04) allows companies on the OTC Bulletin Board and Pink Sheets to be eligible portfolio companies, and it notes that few analysts cover these issuers. As examples of why these issuers have problems accessing the capital markets, see footnote 31 of the proposed rule.

- For all categories with market capitalizations below $300 million, institutional ownership does not exceed 40%, compared to at least 65% for those above $700 million.

- The average trading volume ranges from $40,000 to $1.21 million for those with market caps below $300 million, while it is at least $23.09 million for those with market caps greater than $700 million.

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[12] OEA Memorandum from Lori Walsh, Subject: Summary Statistics of Characteristics of Public, December 3, 2004.

- In addition, the data shows that for all public debt and equity offerings between 1997-2003, only 3.4% were made available to companies with market caps below $300 million.

The statistics, provided by the SEC staff, suggest to us that the House legislation, H.R. 3170, appropriately establishes an appropriate threshold ($250 million) distinguishing those companies with greater problems accessing capital compared to those that do not.

5. The proposal fails to recognize the interests of BDC shareholders.

Simply put, the proposal does not protect BDC shareholders as it substantially increases the risk profile of a BDC.

A purpose of the SBIIA was to allow, through BDCs, public investment in small business and venture capital. The SBIIA does not direct BDCs to invest in debtor-in-possession ("DIP") financing, which is a different line of investment with different risks. However, the Commission's proposal focuses on this very type of risky investment for eligibility for the 70% basket. It largely limits a BDC's investments in public companies to those that are in financial distress, thus increasing the risk profile of BDCs.

For example, the proposal allows a BDC's 70% basket to include public companies listed on the Pink Sheets and Over-the-Counter Bulletin Board (OTCBB), as well as those listed on an Exchange or NASDAQ that have received notice that they do not meet the quantitative listing requirements, **and** they do not meet the initial listing requirements for **any** Exchange or NASDAQ. Beyond the fact that the latter requirement is bureaucratic, burdensome, and without any empirical or other justification, the proposal effectively limits a BDC's investments to public companies in serious financial distress.

It appears that the SEC's rule has focused almost exclusively on companies that are "financially troubled businesses," at the expense of "small, developing businesses."[13] The legislative history gives weight to both sets of companies, explaining that the purpose of the legislation was "to increase the flow of capital to small, developing businesses **or** financially troubled businesses" [emphasis added].[14] As such, according to legislative history, 70% basket companies do not necessarily need to be financially troubled. However, the Commission's proposal suggests that public eligible portfolio company investments be financially troubled since they are limited to the Pink Sheets, the OTCBB and those companies facing delisting.

Companies facing the prospect of delisting, and even many Pink Sheet and OTCBB companies, are often in those situations due to financial strain. They are sometimes facing bankruptcy proceedings and thus need debtor-in-possession ("DIP") financing. The Commission's proposal would push BDC's to pursue DIP financing investments, of which they have little, if any, expertise.

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[13] House Report, p. 31.
[14] Ibid.

The other group of entities in which the proposed rule suggests BDC's should invest are companies listed on the Pink Sheets and Bulletin Board. Some companies listed on such markets include shell companies and penny stocks, companies which the Commission has made ineligible for certain other relief because of "prior substantial abuses."[15] It is unclear to us why a proposed SEC rule should encourage investments by BDCs in these companies, and whether the Commission has considered the interests of BDC shareholders in that regard. Such financings would increase the risk profile of the BDC, in turn impacting BDC shareholders, whom the Commission is charged to help protect.

Conclusion

We appreciate that the Commission has joined our efforts to encourage small business capital formation by modernizing the definition of eligible portfolio company. We strongly encourage you to update the definition of eligible portfolio company to ensure that the pool of eligible BDC investments is broad and includes those public companies that face challenges in accessing capital, rather than the very restrictive approach taken by the proposed rule.

We look forward to working with you to ensure that small businesses are not artificially prevented from accessing capital needed for their growth. Small businesses continue to be key drivers for US economic and job growth. We urge the Commission to adopt a rule similar to the provisions in HR 3170, rather than one that unduly restricts BDCs' ability to carry out their Congressionally mandated mission.

Thank you for your attention to these matters of importance to small businesses and the economy.

Sincerely,

Sue Kelly
Member of Congress

Nydia Velázquez
Member of Congress

cc: The Honorable Commissioner Paul S. Atkins
The Honorable Commissioner Roel C. Campos
The Honorable Commissioner Cynthia A. Glassman
The Honorable Commissioner Harvey J. Goldschmid
Giovanni Prezioso, General Counsel

[15] Securities Offering Reform, See Footnotes 108 and 162.