NASAA

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.
750 First Street N.E., Suite 1140
Washington, D.C. 20002
202/737-0900
Fax: 202/783-3571
www.nasaa.org

June 15, 2015

The Honorable Scott Garrett
Chairman
House Committee on Financial Services
Subcommittee on Capital Markets
Washington, D.C. 20515

The Honorable Carolyn Maloney
Ranking Member
House Committee on Financial Services
Subcommittee on Subcommittee on Capital Markets
Washington, D.C. 20515

Re: June 16, 2015 Hearing of the House Financial Services Subcommittee on Capital Markets

Dear Chairman Garrett and Ranking Member Maloney:

On behalf of the North American Securities Administrators Association ("NASAA"),[1] I write to offer comment on legislation that will be the subject of a legislative hearing in the House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises tomorrow.

(1) <u>The Fair Investment Opportunities for Professional Experts Act</u> (H.R. 2187)

The Fair Investment Opportunities for Professional Experts Act would expand the number of persons who qualify as accredited investors, as that term is currently defined by the Securities and Exchange Commission ("Commission" or "SEC") pursuant to Rule 501 of Regulation D. The list of accredited investors, currently, includes: (i) any natural person whose individual net worth, or joint net worth with that person's spouse at the time of his purchase, exceeds $1,000,000 (with exclusions related to the value of the person's primary residence) or (ii) any natural person who had an individual income in excess of $200,000 in each of the two most recent years, or joint income with that person's spouse in excess of $300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.

The Fair Investment Opportunities for Professional Experts Act expands the categories of persons treated as accredited investors under Rule 501, but without regard to income or net worth, to include: (i) registered broker-dealers, SEC-registered investment advisers, attorneys, and accountants; (ii) persons who use the services of a registered broker-dealer to make an investment decision regarding the securities being offered; and (iii) any person "licensed"[2] as an accredited investor by the Financial Industry Regulatory Authority ("FINRA") by virtue of having passed a test conforming to criteria established by the SEC. Further, in order to establish an individual's accredited status under the new

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

[2] H.R. 2187 purports to establish processes under which an individual may become "licensed as an accredited investor by the Financial Industry Regulatory Authority." However, as a self-regulatory organization, FINRA lacks authority to issue any such license. NASAA recommends that this provision be clarified.

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categories, the bill would permit what amounts to "self-certification," requiring only that the purchaser "certifies to the issuer prior to the sale of securities to such person that he" is an accredited investor.

As the Subcommittee is aware, NASAA has long advocated for updating and improving the accredited investor standard in the interest of investor protection.[3] The current income and net worth standards were established in 1982, and have not been adjusted for inflation. In that regard, while we appreciate that H.R. 2187 recognizes a need to modernize the standard, we have serious concerns about the approach taken under the bill.

The legislation's foundational premise – that any person simply holding a specified educational requirement or professional designation should be deemed an accredited investor – is problematic. This approach fails to consider other important factors, such as the person's actual investment experience, net worth, or bona fide financial sophistication. NASAA acknowledges the potential for correlation between a person's professional training and their financial sophistication, but urges Congress to exercise great caution in considering legislation that would deem factors such as completion of a state bar exam or FINRA financial exam as, by themselves, sufficient grounds to establish in all cases an individual's ability to fend for his or her own interests in an opaque, illiquid marketplace, such as exists for Regulation D, Rule 506 securities.[4]

NASAA has similar concerns regarding the provisions of the bill that would award accredited status to *any* investor who has retained and used the services of a registered broker-dealer to make an investment decision irrespective of relevant criterion such as the investor's financial sophistication. Indeed, because many retail investors in the United States rely upon the services of broker-dealers when buying and selling securities, the practical effect of such a provision would be to immediately "deem" such individuals to be accredited investors, thereby exposing a potentially enormous new population of retail investors to the acknowledged risks inherent in investing in private, unlisted securities.

Finally, NASAA has significant concern regarding the bill's requirement for the development of a new test that would permit individuals to be "licensed" as accredited irrespective of any other factor or circumstance. While NASAA acknowledges that such a test, properly constructed and administered, could prove to be a useful tool for measuring some aspects of an investor's financial sophistication, we also note that accredited status is generally understood to denote more than mere conceptual mastery of skills like those that may be tested by examination. Indeed, as the SEC's Investor Advisory Committee recently noted in its recommendation regarding the accredited investor definition:

> "Over the years, analysis of whether a particular class of individuals needs the protections of the [Securities] Act has generally turned on three factors: 1) whether the individuals have (or are able to negotiate) access "to the same kind of information that the [Securities] Act would make available in the form of a registration statement;" 2) whether the individuals can bear the economic risks of the offering, including risks associated with the illiquidity of private offerings and the risk of loss; and 3) whether the individuals are sufficiently financially sophisticated, based on their knowledge and experience and in particular their ability to evaluate risks and

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[3] See: Comment letter of Joseph Borg, NASAA President and Alabama Securities Commissioner, regarding Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles; Securities Act Release No. 33-8766; Investment Advisers Act Release No. 2576, 72 FR 400 (Jan. 4, 2007)

[4] Private offerings inherently have limited secondary market liquidity, and the pricing of such securities is less transparent since they are not traded in the public securities market. In addition, the initial and on-going disclosure obligations of the issuers of such securities are not subject to the same Commission rules, but rather are determined exclusively by the issuer or are subject to negotiation and agreement between the issuer and the investor. These attributes make private investments more appropriate for sophisticated investors who understand these risks and have the ability to negotiate access to information. *See:* Recommendation of the SEC Investor Advisory Committee: Accredited Investor Definition. (Oct 9, 2014.) Available at https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-advisor-accredited-definition.pdf

merits, to make an informed investment decision without the full disclosure provided in a public offering."[5]

In NASAA's view, absent the consideration of additional factors, it is difficult to understand how a test administered by FINRA could qualify major components of the accredited investor standard. It is unclear how such a test could reliably establish an individual's actual ability to "negotiate access" to "the same kind of information that the [Securities] Act would make available," or discern whether such individual is in a position to "bear the economic risks of the offering, including risks associated with the illiquidity of private offerings and the risk of loss." Again, NASAA appreciates that such an examination could yield information pertinent to the question of whether individuals are financially sophisticated, based on their knowledge. However, we believe that *actual experience,* taking into consideration the investments owned by an investor, is the best indicator in this regard.[6]

Although NASAA disagrees with certain aspects of H.R. 2187, state securities regulators share and support Congress's general interest in revisiting and updating the accredited investor standard. As a first step, NASAA would strongly encourage Congress to support the SEC's effort to gather information about the Regulation D private-placement market, about which remarkably little is known, despite its rivaling the public markets in size.[7] Specifically, Congress should urge the SEC to adopt the rules proposed in July, 2013, that would require additional disclosures by issuers selling securities in reliance on Rule 506, including filings of Form D, both preceding, and subsequent to the offering.[8] These rules are essential and already long overdue.

Finally, NASAA would also note that the Dodd-Frank Act requires the SEC to undertake a review of the accredited investor definition in its entirety as it relates to natural persons every four years, beginning in 2014. The SEC staff is in the midst of conducting a comprehensive review of this definition, and as of June 12, 2015, approximately 413 comment letters dealing with the accredited definition had been received.[9] In NASAA's view, given the scope of the SEC's review and the fact that it is already well underway, Congress should await the results and recommendations prior to making the substantial changes contemplated by H.R. 2187.

(2) <u>The Small Business Credit Availability Act</u> (Discussion Draft)

Today, the Subcommittee will also consider a discussion draft bill ("bill" or "proposed bill") that would relax portfolio strictures, leverage limits, and other regulations for business development companies ("BDCs"). NASAA commented on similar language in three bills proposed in October 2013.[10]

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[5] Recommendation of the SEC Investor Advisory Committee. The Accredited Investor Definition. https://www.sec.gov/spotlight/investor-advisory-committee-2012/accredited-investor-definition-recommendation.pdf

[6] NASAA has long advocated in favor of an "investments owned" test as an alternative basis for determining accredited investor status in addition to the existing net worth and income standards. We note that SEC proposed a form of "investments owned" test as an alternative basis for determining accredited investor status in 2007. (Securities Act Release 33-8828)

[7] As the Commission noted in the release for the final rule lifting the ban on general solicitation in Rule 506 offerings, it has "relatively little information on the types and number of investors in Rule 506 offerings."

[8] The SEC's Proposing Release notes that the pre-filing requirement is intended, in part, to enhance the SEC's understanding of the Rule 506 market by improving compliance with Form D filing requirements. See, SEC Release 33-9416, 34-69960, IC-30595, Amendments to Regulation D, Form D and Rule 156 (July 10, 2013), 78 Fed. Reg. 44806 (July 24, 2013). http://www.gpo.gov/fdsys/pkg/FR-2013-07-24/html/2013-16884.htm

[9] See: Comments on Proposed Rule: Amendments to Regulation D, Form D and Rule 156 under the Securities Act [Release Nos. 33-9416, 34-69960, IC-30595; File No. S7-06-13]. Available at: http://www.sec.gov/comments/s7-06-13/s70613.shtml

[10] Testimony of A. Heath Abshure, October 23, 2013, "Legislation to Further Reduce Impediments to Capital Formation," available at http://www.nasaa.org/27276/legislation-reduce-impediments-capital-formation/.

BDCs are regulated, closed-end investment firms that invest in small, developing or financially troubled companies. Although governed by the Investment Company Act of 1940 (“ICA”), BDCs are unique in that they enjoy a number of important exemptions from the ICA. For instance, BDCs are permitted to use more leverage than a traditional mutual fund – up to and including a 1-to-1 debt-to-equity ratio, and BDCs can engage in affiliate transactions with portfolio companies. BDC managers also have access to “permanent capital” that is not subject to shareholder redemption. In exchange for such regulatory latitude, BDCs must adhere to certain portfolio strictures not applicable to other registered funds. Most prominently, BDCs are required to maintain an asset coverage ratio of 200%, at least 70% of which must be in “eligible” investments.[11] In addition, under Section 12(d)(3) of the ICA, a BDC generally cannot acquire securities issued by a broker-dealer, an underwriter or an investment adviser of an investment company, or a registered investment adviser, except under limited circumstances.

Section 2: BDC Ownership of Securities of Investment Advisers and Financial Companies

NASAA has concerns about Section 2 of the bill, which would allow BDCs to invest in investment advisers and certain financial companies. We are also concerned with language that would redefine an “eligible portfolio company” as an investment company other than a private equity company or hedge fund, and the resulting diversion of BDC funds from the companies that BDCs were intended to benefit.

The proposed bill contains significant conflicts of interest. Specifically, Section 2(a) of the bill would remove prohibitions on the ability of BDCs to invest in investment advisers and financial companies. If an advisory firm were among a BDC’s portfolio of companies, an incentive could exist for the investment adviser to recommend, or even push, clients toward investments in the BDC or its other portfolio companies. Such conflicts of interest could be even more troublesome in the context of an investment adviser’s discretionary or “managed” accounts, where the adviser is delegated authority to make investment decisions on behalf of the client. These inherent conflicts could interfere with an investment adviser’s fiduciary duty obligations to its clients and the BDC as a shareholder. Allowing such potential conflicts of interest are also contrary to the express purpose and activities of BDCs. Competition from financial firms will not benefit traditional BDC portfolio companies, and may allow a BDC to access the advisory firm’s pool of capital to shore up an underperforming portfolio company. No such conflicts of interest exist now, and NASAA urges Congress not to enact legislation that would result in such conflicts as it considers reforms to BDC portfolio strictures.[12]

The proposed bill could also have an adverse impact on BDC transparency, and increase the risk to retail investors. Sections 2(b) and 2(c) would redefine an “eligible portfolio company” as almost any type of investment company other than a private equity company or hedge fund, and provides that a BDC may invest up to 50% of its “total assets” (20% more than currently allowed) in any type of eligible or non-eligible company. NASAA has significant concerns regarding these proposed changes to BDC portfolio strictures. Because BDCs are frequently “blind pool” offerings, retail investors may only receive broad, vague disclosures about the underlying investment portfolio. It is these “retail” investors

[11] Eligible investments include: (1) privately issued securities purchased from “eligible portfolio companies,” (2) securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director, (3) privately issued securities of companies subject to a bankruptcy proceeding, or otherwise unable to meet their obligations, (4) cash, government securities or high quality debt securities maturing in less than one (5) facilities maintained to conduct the business of the BDC, such as office furniture and equipment, interests in real estate and leasehold improvements.

[12] Congress should, at a minimum, require the SEC to adopt rules addressing any potential conflicts prior to permitting this investment.

who would bear the loss if the BDC invested in riskier products such as payday lenders and installment programs, REITS, or other structured products.[13]

Section 3: Expanding Access to Capital for Business Development Companies

In 2013, NASAA testified that it questioned the rationale for further relaxing the leverage limits applicable to BDCs.[14] Excessive leverage by some of our largest financial institutions was in part responsible for the problems we faced in the most recent financial crisis. In our 2013 testimony, we stated that because an increase in leverage increases the risk to investors, we would be disinclined to support such a change absent sufficient justification.

NASAA appreciates that the current bill incorporates several important improvements to the previous legislation. Specifically, the bill requires reporting and non-reporting companies to provide notice and disclosure about new asset coverage ratios; confirms the required approval by a majority of independent directors or general partners; and provides other protections to shareholders regarding a possible increase in leverage.[15] We believe that such protections are important and should apply in all instances, including the ability to resell stock back to the company following a change in asset ratio coverage.

NASAA understands that certain small and mid-sized operating companies may confront challenges accessing credit and investment capital where these challenges may not have existed in the past, and that in some cases, permitting BDC's to take on greater leverage to invest in such companies could benefit such companies and BDC shareholders. However, as NASAA and others have noted,[16] adjusting the leverage limits applicable to BDCs has inherent potential to put retail investors at significantly increased risk. NASAA's concerns in this regard are greatly exacerbated under the present bill due to its substantial, inexplicable relaxation of existing BDC portfolio restrictions. In our view, should Congress ultimately conclude that a modest adjustment to BDC asset coverage ratios for well-established BDCS is in order, it should carefully consider the increased risks that such changes could

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[13] Under existing law, at least 70% of a BDC's total assets must be invested in allowable investments. Among such investments are securities issued by an "eligible portfolio company," a term that is narrowly defined. An "eligible portfolio company" includes domestic operating companies with no class of securities listed on a national securities exchange as well as securities listed on a national exchange so long as the company has a market capitalization of less than $250 million. Section 2(b) of the bill would include a number of previously excluded companies in the definition of an "eligible portfolio company" including: underwriters and brokers of securities, banks or insurance companies, small business lenders, firms engaged in consumer finance or purchasing receivables, inventory financing, mortgage financing, and entities whose business is owning oil and gas or mineral related assets. Section 2(c) of the bill would permit BDCs to invest up to 50% of their total assets in eligible or non-eligible portfolio companies—20% more than BDCs may currently invest in such companies.

[14] The current asset coverage ratio applicable to BDCs is 200%. This means that every dollar of a BDC's debt must be "covered" by two dollars of BDC assets, effectively limiting a BDC's leverage ratio to 50% of assets.

[15] The bill provides for two options: (i) it makes any change in the leverage ratio effective one year after director approval, and provides that for non-listed BDCs each person who is a shareholder as of the date of approval shall have a right to tender their equity securities as of that date, with 25% of the total outstanding securities available for repurchase in each of the four quarters following approval of the increased leverage; or (ii) at a special or annual shareholder meeting in which a quorum is present, the company receives the approval of more than 50% of the votes cast to increase leverage, whereupon the increase in leverage would become immediately effective. We believe that the protections provided in (i) should apply in all cases.

[16] As SEC Chair Mary Jo White noted in a letter to the Subcommittee when it was considering similar legislation to relax BDC leverage limits in October, 2013: "[An] increase in the ability of BDCs to use leverage, and the elimination of provisions of the [Securities] Act intended to protect holders of preferred stock issued by a BDC, gives rise to investor protection concerns, particularly because most BDC shareholders are retail investors." Letter from SEC Chair Mary Jo White to House Financial Services Subcommittee Chairman Scott Garrett and Ranking Member Carolyn Maloney. October 13, 2013.

create for retail investors, and examine what if any steps can be taken to mitigate such risks.[17] NASAA would be pleased to work with Congress in this regard.

Section 3(a)(3) of the bill amends Section 61(a) of the ICA to allow BDCs to issue senior equity in addition to the current authorization to issue only senior debt. We question the necessity of issuing senior equity securities that will have greater preferences, including realized returns, over existing common shareholders. We also question the impact that removal of the word "voting" from 61(a)(3)(A) of the ICA (in Section 3(a)(4) of the bill) will have on common shareholders. Section 3(a)(5) of the bill provides extensive relief from voting rights requirements and the right to elect directors in the event of default except in certain instances. Congress should consider whether the relief should also be inapplicable to issuances of debt to investors that are not qualified institutional buyers. Finally, Section 3(a)(5) of the bill contains language that would allow BDCs to issue multiple classes of debt securities and senior equity securities, which would dilute the value of common stock. We encourage Congress to require that if additional preferred stock is allowed, that it be counted as debt and not as equity.

Section 4: Parity for Business Development Companies Regarding Offering and Proxy Rules

Finally, state securities regulators understand and support sensible modernization of regulations applicable to BDCs and other companies, and we support the proposal to extend the relaxed regulatory requirements available to Well Known Seasoned Issuers and certain other large public filers to BDCs. However, we believe that any rule revisions by the SEC should be required to be completed before making the provisions of this bill effective.

Thank you for considering NASAA's views on the legislation before the subcommittee. State securities regulators look forward to working with Congress on these and similar efforts to promote efficient capital formation and modernized investor protection frameworks. Should you have any questions, please do not hesitate to contact me.

Sincerely,

William Beatty
NASAA President
Washington Securities Administrator

[17] For example, Congress could require that any reduced leverage restrictions would only be available to seasoned BDCs that have demonstrated debt service capabilities for at least five years.