REISA
ALTERNATIVE INVESTMENTS
Education ▲ Networking ▲ Advocacy

June 29, 2012

Submitted via Fedex

Richard A. Fleming
Deputy General Counsel
North American Securities Administrators Association
750 First Street, NE, Suite 1140
Washington, DC 20002

Dear Mr. Fleming:

Thank you for allowing us to provide the Direct Participation Program Policy Project Group (the "***DPP Group***") with our views on the drafting of a new NASAA Statement of Policy that would set forth guidelines for states and jurisdictions to follow in connection with their review of registration statements filed by business development companies ("***BDCs***"). For the reasons noted below, we believe that a new Statement of Policy that is tailored to BDCs is necessary in order to take into account the unique characteristics of BDCs and the multiple levels of existing regulation to which BDCs are subject.

The Real Estate Investment Securities Association ("***REISA***") is a national trade association of decision makers that influence over 20,000 professionals who offer or manage alternative investments. These typically include, but are not limited to: non-traded REITs, non-traded BDCs, real estate partnerships, real estate income and development funds, tenant-in-common interests, oil and gas interests, and other securitized real estate investments.

Currently, registration statements filed by BDCs are primarily regulated by NASAA's Omnibus Guidelines ("***Omnibus Guidelines***"). The Omnibus Guidelines were created to assist state regulators in their review of investment products that do not fit into any of the other Statements of Policy published by NASAA. The investment programs regulated by the Omnibus Guidelines may be structured as partnerships or limited liability companies and are often not subject to a substantive regulatory structure, such as the Investment Company Act of 1940, as amended (the "***1940 Act***"). The Omnibus Guidelines, in other words, were not drafted to regulate offerings by regulated entities such as BDCs. As a result, a number of jurisdictions also look to certain provisions of the NASAA REIT Guidelines in connection with their review of BDC registration statements. This practice is not consistent from jurisdiction to jurisdiction, however, and has caused additional uncertainty for non-listed BDC sponsors.

While REISA fully supports the creation of a new Statement of Policy for BDCs ("***BDC Guidelines***"), we also think it is important for the DPP Group to provide interim guidance to the state securities administrators to promote uniformity in how jurisdictions review registration statements by BDCs. Specifically, we believe that BDCs are subject to greater regulation and are more transparent than REITs and, as a result, should not be subject to some of the more burdensome requirements found in the Omnibus Guidelines that are not applicable to REITs or other operating companies.

Overview of BDCs

As you may know, a BDC is a special category of investment company under the 1940 Act that was added by Congress to facilitate the flow of capital to private companies and small public companies that do not have efficient or cost-effective access to public capital markets or other conventional forms of corporate financing. BDCs make investments in private or thinly-traded public companies in the form of long-term debt and/or equity capital, with the goal of generating current income or capital growth.

BDCs are closed-end funds that elect to be regulated as BDCs under the 1940 Act. As such, BDCs are subject to only certain provisions of the 1940 Act, as well as the Securities Act of 1933, as amended (the "***Securities Act***") and the Securities Exchange Act of 1934, as amended (the "***Exchange Act***"). BDCs are provided greater flexibility under the 1940 Act than other investment companies in certain areas, including (a) dealing with their portfolio companies, (b) issuing securities, and (c) compensating their managers. BDCs can be internally or externally managed and generally elect to be taxed as Regulated Investment Companies ("***RICs***") for federal income tax purposes. RICs and REITs are both regulated under Subchapter M of the Internal Revenue Code of 1986, as amended (the "***Code***") and, therefore, have very similar requirements. For example, both REITs and RICs are subject to asset diversification and annual distribution requirements. If a BDC qualifies as a RIC and distributes at least 90% of its investment company taxable income to its stockholders, it will generally not be subject to federal income taxes. As with REITs, the annual distribution requirement is a feature that is particularly conducive to a non-listed structure.

Since FS Investment Corporation filed its initial registration statement on Form N-2 with the SEC in February 2008, nine other non-listed BDCs have filed registration statements with the SEC, including seven that have been declared effective by the SEC and are offering their securities to the public. To date, non-listed BDCs have sold in excess of $3.0 billion in offerings of common stock.

How BDCs contrast with REITs

Like REITs, BDCs file registration statements under the Securities Act and are regulated under the Securities Act and the Exchange Act. However, unlike REITs, BDCs are investment companies and are also subject to certain provisions of the 1940 Act. The 1940 Act provides a substantive regulatory structure that serves to supplement the disclosure-oriented regulatory structure of the Securities Act and Exchange Act to which all public issuers are subject. In order to qualify as a BDC, an entity must be taxed as a corporation and must have a class of equity securities registered under Section 12 of the Exchange Act. In addition, a BDC must at all times have a board of directors, a majority of whom are independent, and that must value the BDC's assets on at least a quarterly basis. Finally, the 1940 Act requires that a BDC's board of directors, including a majority of its independent directors, approve at least annually, at an in-person meeting of the board of directors, any investment advisory agreement involving the BDC.

Registration under Section 12 of the Exchange Act

These requirements are specifically designed to protect investors. By having its equity securities registered under Section 12 of the Exchange Act, BDCs are subject to the periodic reporting requirements of Section 13(a) of the Exchange Act which requires BDCs to continue filing periodic reports beyond the BDC's offering period. These reporting requirements only lapse the first year following the date on which the BDC has fewer than 300 record holders of its securities. In addition, registration under Section 12 of the Exchange Act imposes filing requirements under Section 16 of the Exchange Act on all officers and directors of a BDC which requires that each of them report their ownership of the BDC's securities and prohibits them from receiving any short-swing profits relating to the disposition of the BDC's equity securities.

REITs, on the other hand, are not required to register their securities under the Exchange Act, although most do. Instead, REITs that do not register their securities under Section 12 of the Exchange Act are required to file periodic reports pursuant to Section 15(d) of the Exchange Act during the offering period and one year following the termination of the offering. Further, REITs who do not register their securities under Section 12 of the Exchange Act are not subject to the requirements of Section 16 of the Exchange Act described above.

Valuation

On at least a quarterly basis, a BDC's board of directors, including its independent directors, is tasked with, among other things, determining the fair value of the BDC's assets. This valuation process provides stockholders of the BDC with information concerning the value of their securities throughout the offering period and for so long as the BDC remains registered under the Exchange Act. In fact, "net asset value per share" is required to be included as a line item in the financial statements of a BDC. Valuation of a non-listed REIT's assets, on the other hand, is currently not required to be published until after the offering period has concluded.

Investment Advisory Agreements

All investment advisory agreements relating to the BDC must be approved by the board of directors, including a majority of its independent directors. In connection with such approval, the board of directors is required to consider the following factors, to the extent they are applicable:

a) the nature, quality and extent of the advisory and other services to be provided to the BDC by the investment adviser;
b) comparative data with respect to advisory fees or similar expenses paid by other BDCs with similar investment objectives;

c) the BDC's projected operating expenses and expense ratio compared to BDCs with similar investment objectives;
d) any existing and potential sources of indirect income to the investment adviser from its relationships with the BDC and the profitability of those relationships;
e) information about the services to be performed and the personnel performing such services under the investment advisory agreement;
f) the organizational capability and financial condition of the investment adviser and its affiliates;
g) the possibility of obtaining similar services from other third party service providers or through an internally managed structure; and
h) the alignment of incentives of the investment adviser and the BDC's stockholders to be achieved by paying the incentive fee in shares of its common stock.

Certain of the statutory requirements under the 1940 Act that are imposed on investment advisory agreements between a BDC and its investment adviser are similar to the requirements found in Section IV.G. of the REIT Guidelines.

<u>Requests for the BDC Guidelines</u>

There are a number of provisions in the Omnibus Guidelines that REISA believes should not be included in a new Statement of Policy for BDCs and, prior to the enactment of the BDC Guidelines, should not be applicable to BDCs. We have highlighted below three provisions that we believe have caused a tremendous amount of difficulty for non-listed BDC sponsors and have further listed other provisions that we believe are not applicable to BDCs either because they are inconsistent with the BDC structure, are duplicative or inconsistent with the 1940 Act.

Definition of Program Agreement

Section I.B.20. of the Omnibus Guidelines defines "Program" as a "general or limited partnership, joint venture, unincorporated association or similar organization other than a corporation." The Omnibus Guidelines, in other words, were specifically drafted not to apply to corporations. As noted earlier, BDCs are required to elect to be taxed as corporations and generally are formed as corporations. As a result of this, there are a number of provisions included in the Omnibus Guidelines that were drafted to take into account characteristics of limited partnerships and that have no relevance to corporations. A number of jurisdictions have taken the position that, notwithstanding the definition of "Program" found in Section I.B.20. of the Omnibus Guidelines, all of the provisions found in the Omnibus Guidelines should apply to BDCs.

This interpretation is further strained by the fact that there is no definition in the Omnibus Guidelines for the term, "Program Agreement." Section VIII.D. of the Omnibus Guidelines, however, requires that numerous sections of the Omnibus Guidelines be included in the "Program Agreement." A number of jurisdictions have taken the position that all of the requirements found in Section VIII.D. must be included in the BDC's charter.

REISA believes that this interpretation is flawed for the following reasons. First, this treatment is not consistent with the REIT Guidelines where the definition of "Declaration of Trust" specifically includes more than just the declaration of trust. It is defined to include the "declaration of trust, bylaws, certificate, articles of incorporation, or other governing instrument pursuant to which a REIT is organized." In other words, even though Section VIII.A. of the REIT Guidelines is comparable to Section VIII.D. of the Omnibus Guidelines in that it specifies the provisions in the REIT Guidelines that must be included in the "Declaration of Trust," REITs are permitted to satisfy these requirements in their bylaws or other governing instrument pursuant to which the REIT is organized. REISA respectfully requests that the term "Program Agreement" be defined in the BDC Guidelines in a manner consistent with the REIT Guidelines to include the charter, bylaws and other governing instruments pursuant to which the BDC is organized, including the investment advisory agreement discussed below.

All of the non-listed BDCs currently in the marketplace and in registration are externally managed by a registered investment adviser. As a result, the investment advisory agreement between the BDC and its investment adviser should be included in the definition of "Program Agreement." In addition, REISA notes that certain requirements found in the Omnibus Guidelines impose requirements on the "Sponsor." The equivalent entity in a BDC is typically the investment adviser; however, the investment adviser is not a party to the BDC's charter, and therefore requiring inclusion of these requirements in a BDC's charter may be unenforceable against the investment adviser.

Further, investment advisory agreements are regulated under Section 15 of the 1940 Act. Section 15 requires either the board of directors of the BDC, which must be comprised of a majority of independent directors, or a majority of outstanding voting securities to approve, on an annual basis, the terms of any advisory agreement. Similarly, Section 15 provides for certain termination provisions that must be included in an investment advisory agreement. Finally, in connection with the approval of an investment advisory agreement, the board of directors is required to request and evaluate any information related to, among other things,

a) the nature and quality of the services provided by the investment adviser,
b) the investment performance of the investment adviser and its advisory personnel,
c) the financial condition and expenses of the investment adviser and
d) whether the fees charged by the investment adviser are appropriate.

These provisions are designed to protect investors and ensure that the board of directors of a BDC, including its independent directors, have an active role in engaging an investment adviser, ensuring that such investment adviser is performing as expected and that its fees and expenses are reasonable.

REISA therefore recommends that the term "Program Agreement" be defined in the BDC Guidelines to include the charter, bylaws, investment advisory agreement and any other governing document pursuant to which the BDC is organized. This standard is consistent with the definition of "Declaration of Trust" in the REIT Guidelines and would eliminate the confusion currently surrounding the term in the Omnibus Guidelines.

In addition, REISA respectfully requests that the DPP Group provide interim guidance to the state securities administrators regarding the definition of "Program Agreement" as outlined above.

Sponsor Net Worth Requirements

Section II.B. of the Omnibus Guidelines requires minimum net worth requirements for a "[s]ponsor liable for the debts of the" BDC. This net worth requirement is not found in the REIT Guidelines and is problematic for BDCs in two respects. First, as noted above, BDCs are generally organized as corporations and are, therefore, owned by their stockholders. As a result, the concept of a sponsor entity being liable for the debts of the program is not applicable to BDCs as they are not limited partnerships or limited liability companies. Second, the required net worth of a sponsor entity is not proportionate to the expenses required to conduct the business of the BDC.

A number of jurisdictions reviewing BDC offerings currently disregard the net worth concept relating to a sponsor being liable for the debts of the program and simply require that affiliated person(s) or entit(ies) provide audited financial statements demonstrating the net worth requirements of Section II.B. This appears to result in more established sponsors receiving preferential treatment by jurisdictions that require a minimum net worth for a related entity, regardless of whether such entity is liable for the debts of the BDC.

A non-listed BDC offering is structured similarly to a non-listed REIT offering. Typically, the investment adviser or some other affiliated entity advances the expenses on behalf of the BDC and is entitled to reimbursements as gross offering proceeds are received. As a result, if the BDC is unsuccessful in raising offering proceeds in its public offering, the investment adviser or other entity that advanced the BDC's expenses will not be entitled to reimbursements sufficient to cover their expenses. These upfront expenses can be substantial, and sponsors generally are able to receive reimbursement for all of these expenses only if the public offering raises significant sums.

The required net worth for a sponsor entity under the Omnibus Guidelines is equal to 5% of the first $20 million offered in the proposed offering as well as the "gross amount of any originally issued direct participation program securities sold by the Sponsor within the prior 12 months" plus 1% of all amounts in excess of $20 million. For a public offering of up to $1.5 billion of securities, which is a common amount for non-listed BDC and REIT offerings, this provision would require that the sponsor of the BDC have a net worth (exclusive of home, automobiles and home furnishings) of at least $15.8 million. In addition, if the Sponsor (which is broadly defined in the Omnibus Guidelines) has conducted a separate non-listed offering for another entity during the prior 12 months, this amount could be significantly higher.

REISA believes that the BDC Guidelines should track Section II.A. of the REIT Guidelines and require a minimum amount of capital be contributed to the BDC equal to the lesser of 10% of the total net assets of the program and $200,000 rather than the net worth requirement which is more suited to a limited partnership structure than a corporate structure. This ensures that BDCs are treated substantially similar to REITs and not to limited partnerships.

In addition, since Section II.B. of the Omnibus Guidelines currently imposes these excessive net worth requirements unlike those required by any other Statements of Policies relating to operating companies , REISA respectfully requests that the DPP Group provide interim guidance to the state securities administrators to apply Section II.A. of the REIT Guidelines to BDCs rather than Section II.B. of the Omnibus Guidelines.

Audited Financial Statements

In conjunction with the sponsor net worth requirement found in Section II.B., which is discussed above, Section VIII.C. of the Omnibus Guidelines also requires that audited financial statements of a sponsor entity be provided as an exhibit to the application with the states. In addition to the financial statements of the Program, financial statements of a corporate or partnership sponsor or one or more individuals who are included in the definition of "Sponsor" are required to be included as part of such application. REISA believes that this requirement was included in the Omnibus Guidelines as drafted to apply to limited partnerships. This is consistent with the position found in Section 2805 of the SEC's Division of Corporation Finance's Accounting Training Manual, that requires audited financial statements of a general partner where the SEC registrant is a limited partner. Such financial statements must be included in the registrant's registration statement and be updated as required for the registrant. The SEC never requires the inclusion of audited financial statements of a sponsor entity where the registrant is a corporation.

As noted earlier, BDCs are generally organized as corporations and not limited partnerships and are subject to the reporting requirements found in Section 13(a) of the Exchange Act. As such, BDCs must include audited financial statements that must be updated in accordance with the requirements of Regulation S-X of the Exchange Act. Obtaining audited financial statements for a sponsor entity that is not a public reporting company is costly and time-consuming. In addition, since the Sponsor is not liable for the obligations of the BDC, such financial statements are not meaningful to investors. Finally, we note that the REIT Guidelines have no comparable requirement with respect to REIT sponsors.

REISA respectfully requests that the BDC Guidelines not require the submission of audited financial statements of a sponsor entity or individual(s). Similarly, we request that the DPP Group provide interim guidance to the state securities administrators that audited financial statements of a sponsor entity should not be required to be included as part of an application to register the securities of a BDC with the states.

Miscellaneous Provisions

In drafting the BDC Guidelines, REISA also requests that the DPP Group exclude provisions currently found in the Omnibus Guidelines that are specifically intended to apply to limited partnerships, not corporations. In addition, certain of the current requirements found in the Omnibus Guidelines are either required by or, in some cases, are inconsistent with the provisions of the 1940 Act. REISA requests that these provisions either be excluded in the BDC Guidelines or be revised to be consistent with the 1940 Act. REISA would be happy to discuss such provisions with the DPP Group and work to resolve such inconsistencies at the appropriate time.

REISA also respectfully requests that the DPP Group provide interim guidance to the state securities administrators consistent with these requests.

Conclusion

REISA applauds NASAA and, in particular, the DPP Group, for recognizing the need for a new Statement of Policy regarding BDCs and appreciate the opportunity to provide the DPP Group with our views. Please feel free to reach out with any questions relating to the foregoing.

Sincerely,

Daniel Oschin
President
Real Estate Investment Securities Association (REISA)