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Office of Regulations and Interpretations
Office of Exemption Determinations
Employee Benefits Security Administration
(Attention: D-11712)
U.S. Department of Labor
122 C Street, NW
Suite 400
Washington, DC 20001

**Re: Regulatory Definition of the Term “Fiduciary” (RIN 1210-AB32);
Proposed Best Interest Contract Exemption (ZRIN: 1210-ZA25)**

Ladies and Gentlemen:

Franklin Square Holdings, L.P. (“Franklin Square”) appreciates the opportunity to respond to the request for comment regarding the above-referenced Proposed Best Interest Contract Exemption (the “Proposed Exemption”). The Proposed Exemption, and the proposed regulation concerning conflicts of interest in retirement investment advice (the “Proposed Regulation”) to which the Proposed Exemption applies, were published in the Federal Register on April 20, 2015.

Franklin Square is a leading manager of investment funds and is committed to providing our investors access to asset classes, strategies and asset managers historically available only to wealthy individuals and institutional investors, such as university endowments, foundations and defined benefit pension plans. In furtherance of this mission, Franklin Square launched the first non-traded business development company (“BDC”) in 2009. We now manage four BDCs, both traded and non-traded, and have become the largest manager of BDC assets in the country.

SUMMARY OF COMMENT

Franklin Square shares the Department of Labor’s (the “Department”) interest in protecting investors and applauds the obvious care and thoughtfulness that went into the preparation of both the Proposed Regulation and the Proposed Exemption. We strongly support the Department’s goal of protecting plans, participants and beneficiaries, and IRA owners.

We respectfully request that non-traded BDCs be included in the list of investments permitted under the Proposed Exemption. The Department can implement this request by replacing the phrase “registered investment companies” with “investment companies regulated pursuant to the Investment Company Act of 1940,” in Section VIII(c) of the Proposed Exemption, as follows:

(c) An “Asset,” for purposes of this exemption, includes only the following investment products: Bank deposits, certificates of deposit (CDs), shares or interests in ~~registered investment companies~~ **investment companies regulated**

pursuant to the Investment Company Act of 1940, bank collective funds, insurance company separate accounts, exchange-traded REITs, exchange-traded funds, corporate bonds offered pursuant to a registration statement under the Securities Act of 1933, agency debt securities as defined in FINRA Rule 6710(l) or its successor, U.S. Treasury securities as defined in FINRA Rule 6710(p) or its successor, insurance and annuity contracts, guaranteed investment contracts, and equity securities within the meaning of 17 CFR 230.405 that are exchange-traded securities within the meaning of 17 CFR 242.600. . . .

By amending the Proposed Exemption in this narrow manner, just non-traded BDCs would be added to the “Asset” list, and registered investment companies would remain covered by the Proposed Exemption.

We believe this change is consistent with the objectives of the Proposed Regulation for two primary reasons. First, non-traded BDCs offer longer-term investment opportunities that meet the standards set forth in the Proposed Exemption’s preamble.¹ Specifically, non-traded BDCs:

- are subject to robust disclosure requirements that collectively provide investors *a high level of transparency*,
- are designed to be less correlated with the stock market and, therefore, can be an important *part of a well-diversified portfolio*,
- have a *ready market price*, and
- offer investment horizons that are designed to *provide liquidity over time*.

Second, non-traded BDCs are among the most highly-regulated investment vehicles in the marketplace, subject to numerous regulatory regimes, including the Investment Company Act of 1940, as amended (the “1940 Act”), the Securities Act of 1933, as amended (the “Securities Act”), the Securities Exchange Act of 1934, as amended (the “Exchange Act”), the state securities acts of all 50 states and the District of Columbia, and rules administered by the Financial Industry Regulatory Authority, Inc. (“FINRA”). In fact, this regulatory framework provides investors with more protection than those regimes associated with many other types of investments currently on the Department’s proposed list of “Assets.”

Additionally, consistent with the Department’s broader job creation objectives, we also believe that inclusion of non-traded BDCs within the proposed definition of “Assets” will support job creation for small and middle-market American businesses by increasing the flow of capital to these firms.

¹ See 80 Fed. Reg. at 21967.

For these reasons, as discussed in more detail below, non-traded BDCs are appropriate investments to be included in the mix of investments that a fiduciary may recommend under the Proposed Exemption.

BACKGROUND

1. What are BDCs?

BDCs are a type of closed-end investment company that was created by Congress through the enactment of the Small Business Investment Incentive Act of 1980 and corresponding amendments to the 1940 Act (together, the “1980 Amendments”).² Congress’ stated objective in creating BDCs was to encourage the establishment of new capital vehicles that would permit mainstream investors to invest in, and, therefore, increase the flow of capital to, small and mid-sized companies in the United States.³

To qualify as a BDC, a company is generally required to invest at least 70 percent of its total assets in securities of “eligible portfolio companies” as defined in Section 2(a)(46) of the 1940 Act, which generally means the debt or equity securities of private U.S. companies, unlisted public U.S. companies, or listed public U.S. companies that have an aggregate market value of less than \$250 million.⁴ Today, BDCs from across the industry have more than \$70 billion in outstanding investments, the majority of which are in small and middle-market U.S. companies.⁵ Consistent with Congress’ goal of providing support to small and mid-sized U.S. companies, the 1940 Act also requires BDCs to make available significant managerial assistance to portfolio companies.⁶

As referenced above, BDCs also grant mainstream investors access to portfolio-diversifying asset classes historically available only to wealthy individuals and institutional investors – such as university endowments, foundations and defined benefit pension funds – while retaining appropriately high degrees of transparency, regulatory oversight, and investor protection.

2. BDCs, Registered Investment Companies and the Scope of the Proposed Exemption

BDCs are investment companies regulated under the 1940 Act,⁷ and, as such, are regulated in a manner that is substantially similar to registered investment companies, which are included on the proposed definition of “Asset.” BDCs generally fall into two categories: traded BDCs and non-traded BDCs. Traded BDCs are already included on the proposed list of “Assets” because they

² Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980); see also S. Rep. No. 96-958 (1980); H.R. Rep. No. 96-1341 (1980). The Act was approved by the U.S. House by a vote of 395-1 and by unanimous consent in the U.S. Senate.

³ See S. REP. NO. 96-958, at 1, 3 (1980).

⁴ 17 CFR 270.2a-46.

⁵ Small Business Investor Alliance: BDC Modernization Agenda, with data from Wells Fargo Securities, LLC.

⁶ 15 U.S.C. 80a-2(a)(48)(B).

⁷ BDCs must formally elect to be regulated pursuant to the 1940 Act in a filing made with the SEC. See Investment Company Act of 1940 Sec. 54, and SEC Form N-54A.



are listed on an exchange. To provide mainstream investors with the portfolio diversification benefits discussed below, non-traded BDCs are not initially listed on an exchange. For this reason alone, non-traded BDCs are left out of the Proposed Exemption, despite being so markedly similar to registered investment companies and traded BDCs.

3. About Franklin Square

Franklin Square is a national sponsor of investment funds designed for the individual investor. Franklin Square's mission is to enhance mainstream investors' portfolios by providing access to asset classes, strategies, and asset managers typically available only to wealthy individuals and institutional investors. While our funds offer "endowment-style" investment strategies that help construct diversified portfolios and manage risk, we also strive to set the industry standard for best practices, with a focus on transparency, investor protection and education for investment professionals and their clients.

To execute on this mission of bringing institutional quality asset management to mainstream investors, we launched the industry's first non-traded BDC, FS Investment Corporation ("FSIC"), in January 2009. FSIC listed and began trading on the New York Stock Exchange in April 2014 and, therefore, qualifies under the Department's proposed definition of "Asset."⁸ Franklin Square also manages one closed-end registered investment company, which similarly qualifies under the definition of "Asset."⁹ In addition to these two qualifying funds, Franklin Square manages three non-traded BDCs and has two others currently in registration with the SEC.¹⁰

DISCUSSION

As stated above, Franklin Square believes non-traded BDCs should be included among the "Assets" covered by the Proposed Exemption. The following discussion, which is divided into three Sections, explains why in greater detail:

- Section 1 explains that non-traded BDCs meet the standards described in the Proposed Exemption's preamble, making them attractive investments for retirement portfolios.

⁸ On April 16, 2014, FSIC, Franklin Square's first offered fund, listed shares of its common stock on the New York Stock Exchange. Nearly overnight, FSIC became one of the largest publicly traded BDCs and delivered on its goal of providing its stockholders with permanent liquidity. In connection with the listing, FSIC conducted a tender offer for up to \$250 million in shares that allowed FSIC stockholders to tender their shares at a price of \$10.75 per share, representing a premium to the then current trading price of FSIC.

⁹ Franklin Square's registered closed-end investment company, Franklin Square Global Credit Opportunities Fund, commenced operations in December 2013 and continues to raise capital.

¹⁰ Franklin Square currently manages the following non-traded BDCs: FS Energy and Power Fund, which commenced investment operations in July 2011 and continues to raise capital; FS Investment Corporation II ("FSIC II"), which commenced investment operations in June 2012 (after FSIC's continuous public offering was closed to new investors) and closed to new investors in March 2014; and FS Investment Corporation III, which commenced investment operations in April 2014 (after FSIC II's continuous public offering was closed to new investors) and continues to raise capital. Additionally, Franklin Square currently has two non-traded BDCs in registration with the U.S. Securities and Exchange Commission: FS Investment Corporation IV and FS Energy and Power Fund II.

- Section 2 outlines the extensive regulatory and investor protection regimes that apply to non-traded BDCs, demonstrating that non-traded BDCs are as regulated as, and in some respects more regulated than, investments already included as “Assets” in the Proposed Exemption.
- Section 3 summarizes the importance of non-traded BDCs to the American economy.

1. Non-Traded BDCs Meet the Standards Described in the Proposed Exemption’s Preamble, Making them Attractive Investments for Retirement Portfolios.

Non-traded BDCs should be included in the Proposed Exemption because they meet the standards established in the Proposed Exemption’s preamble, namely, non-traded BDCs are: (a) are transparent, (b) form part of a diversified portfolio, (c) have a “ready market price,”¹¹ and (d) are “relatively [] liquid.”¹²

- a) Non-Traded BDCs are Subject to Robust Disclosure Requirements that Collectively Provide a High Degree of Transparency.

Non-traded BDCs are subject to stringent disclosure requirements under the federal securities laws. Robust public disclosures required under the Securities Act, the Exchange Act, the 1940 Act and the SEC rules and regulations thereunder collectively ensure that the activities of all BDCs are fully transparent to regulators, investors, portfolio companies and the general public alike.

Specifically, non-traded BDCs must register their securities under the Securities Act on Form N-2, which requires extensive disclosures regarding, among other things, the issuer, the securities being offered, the issuer’s investment objectives and strategies, risk factors relating to the issuer’s securities and business, and the issuer’s financial condition. Additionally, non-traded BDCs are required to register a class of securities under the Exchange Act and, as such, are required to file periodic and other reports with the SEC, including proxy statements and Forms 10-Q, 10-K, and 8-K. In fact, contained in every 10-Q and 10-K is a schedule of all of a BDC’s investments, along with details regarding the investments such as the name of each portfolio company, the size of each loan or equity position, interest rates, and current price marks.

Non-traded BDCs must also include in their quarterly reports filed with the SEC a section entitled Management’s Discussion and Analysis of Financial Condition and Results of Operations, which, among other things, provides a narrative explanation of the BDC’s financial statements, enabling investors to better see the BDC through the eyes of management.¹³ The Exchange Act also imposes reporting requirements on non-traded BDC directors, officers and principal stockholders

¹¹ See 80 Fed. Reg. at 21967.

¹² We note use of the phrase “relatively [] liquid” in the preamble. Certificates of deposit and variable annuities, both of which are included in the proposed definition of “Asset,” are illiquid and typically impose severe penalties if not held to maturity.

¹³ See 17 C.F.R. § 249.308a (2012) (mandating quarterly reporting on Form 10-Q, which incorporates the reporting requirements set forth in 17 C.F.R. § 229.303 (Item 303 of Regulation S-K)).



with respect to their ownership of, and transactions in, the BDC's securities.¹⁴ Additionally, BDC directors are subject to a common law fiduciary duty to act in the best interest of the BDC and its shareholders – including retirement plan investors. Finally, the 1940 Act imposes additional public reporting requirements on non-traded BDCs, including the requirement that BDCs provide annual disclosure regarding their fidelity bond insurance coverage.

We believe these extensive disclosures make non-traded BDCs more transparent than registered investment companies, and at least as transparent as most of the other types of investments already included in the definition of "Asset."¹⁵

b) Non-Traded BDCs are Less Correlated to Market Volatility, Helping to Diversify Retirement Portfolios.

A primary challenge in creating a diversified retirement portfolio is finding investments that behave differently during varying market conditions. Non-traded BDCs can help meet this objective because they are designed to have a lower correlation to public equity markets.

Three main features generate this lower market correlation.

1. Non-traded BDCs focus primarily on making senior secured loans to private companies. In addition to the stability provided because they sit at the top of the capital structure, senior secured loans to private companies are not highly correlated with more liquid asset classes, such as listed equities.
2. As a result of their continuous public offerings, non-traded BDCs typically have access to ready pools of capital that can be deployed when banks and other entities in the capital markets are not lending. This deployment gives investors exposure to varied vintage cycles and generates returns for investors even in economic downturns, both of which help diversify investor portfolios.
3. As discussed in more detail below, a non-traded BDC's offering price is tied to its net asset value ("NAV"). This feature typically reduces the impact of market volatility not related to changes in the value of the fund's underlying assets, thereby providing a measure of insulation from event-driven market volatility.

c) Non-Traded BDCs Have a Ready Market Price.

Consistent and transparent valuations mandated by the federal securities laws ensure that non-traded BDCs have a ready market price that is reliable and easily ascertainable. As discussed in Section 1(a) above and 2(a) below, the rigorous public reporting regime applicable to non-traded

¹⁴ Exchange Act Sec. 16(a)(1), 15 U.S.C. 78p(a)(1).

¹⁵ This transparency is further enhanced by extensive valuation requirements under the 1940 Act and applicable accounting standards to which traded and non-traded BDCs are subject. See Section 1(c), *infra*.



BDCs under various SEC regulations provides investors with a clear and consistent stream of information regarding a BDC's financial and operating results.

In addition, a non-traded BDC is required to assign a fair value to each of its portfolio assets, and a BDC's board of directors is required to oversee the valuation process and to determine the overall NAV of the BDC on at least a quarterly basis. As such, each security held by a non-traded BDC is valued at market value if there is an existing trading market for such security, and, if not, at the security's fair value as determined in good faith using a consistently applied valuation process adopted by, and under the supervision of, the BDC's board of directors.¹⁶

The existing regulatory regime also has checks to ensure valuations are reliable. First, valuations are subject to the BDC board's fiduciary obligations to shareholders – including retirement plan investors. As part of its commitment to industry best practices, Franklin Square uses third-party pricing and valuation services to determine, subject to the approval of our independent board, the fair value of all our non-traded BDCs' assets on a quarterly basis. Second, the fair value ascribed to each of a non-traded BDC's portfolio assets must be separately disclosed on a "Schedule of Investments" that is included in the financial statements filed quarterly with the SEC as part of the BDC's periodic reports pursuant to the Exchange Act.¹⁷ Third, non-traded BDCs are continuously offered for sale. Under the 1940 Act, the sale price for a BDC's securities must be adjusted to reflect material changes to the fair value of its portfolio because a non-traded BDC is prohibited from selling its securities at a price below its NAV per share (effectively establishing a share price floor).¹⁸ In addition, non-traded BDCs (including Franklin Square's BDCs) have generally adopted pricing policies to limit the amount by which shares can be sold at a price above NAV per share (effectively establishing a share price ceiling).

With these checks in place, and the quarterly reporting of NAV per share based upon the extensive valuation of assets, non-traded BDCs offer a well-vetted, ready market price.

d) Non-Traded BDCs Offer Investment Horizons that Provide Liquidity Over Time.

Although initially less liquid than publicly traded securities, non-traded BDCs' initial holding period plays an important role in providing the diversification benefits discussed above. Non-traded BDCs are generally expected to have a five to seven year holding period prior to initiating a permanent liquidity event, such as a listing on a national securities exchange or merger into an exchange-listed BDC. By carefully selecting the timing of this liquidity event, we believe a non-traded BDC can produce a stronger return for investors than a BDC that lists its securities from day one. This is so because a non-traded BDC has a known portfolio and proven investment track record when it enters the traded markets. While this non-traded BDC model is generally consistent with the income-focused, long-term investment strategy commonly employed by many retirement

¹⁶ The valuation of BDC portfolios is determined in accordance with Accounting Standards Codification Topic 820, "Fair Value Measurements and Disclosures," published by the Federal Accounting Standards Board.

¹⁷ See a more detailed discussion of these disclosures in Section 2(a) of this letter.

¹⁸ See 15 U.S.C. § 80a-62(2) (2012) (applying § 80a-23(b)).

investors, it also offers investors limited liquidity through quarterly redemption rights articulated in its offering documents.¹⁹ Accordingly, non-traded BDCs offer liquidity in two ways – through quarterly redemption programs and full liquidity events, such as a listing or merger.

* * *

In sum, non-traded BDCs have numerous features that protect investors and align with the principles set forth in the preamble to the Proposed Exemption. Of course, non-traded BDCs are not advisable for every investor. The purpose of the Proposed Exemption, however, is not to make an advance judgment that certain investments are appropriate or inappropriate for every investor. Rather, the purpose is to include a broad range of choices, and for investment fiduciaries to consider which choices are in the best interests of their clients. Investment advisers should have the opportunity to assess whether a non-traded BDC, and the diversification and other benefits this investment opportunity can provide, is in their clients' best interests.

2. Non-Traded BDCs Are Subject to Greater Regulation than Registered Investment Companies and Other Types of Investments within the Proposed Definition of “Assets.”

In addition to the features described above that make non-traded BDCs an attractive investment for retirement portfolios, non-traded BDCs are subject to various regulatory regimes that are oftentimes more extensive than the requirements applicable to other types of investments that are currently on the Department's proposed list of “Assets” – including registered investment companies. Below we provide an overview of these regulatory regimes.

- a) Federal Regulation of Non-Traded BDCs is Substantially Similar to, and in Some Aspects More Extensive than, Federal Regulation of Registered Investment Companies.

Non-traded BDCs are among the most highly-regulated investment vehicles in the marketplace. In addition to the robust disclosure requirements discussed in Section 1(a), non-traded BDCs are subject to significant substantive regulation under the 1940 Act and SEC rules and regulations – like registered investment companies. Key elements of these 1940 Act protections include extensive regulations governing portfolio composition, determination of the fair value of investments (which must be completed by the BDC's board of directors at least quarterly), share pricing, director qualifications and independence, transactions with affiliates, bonding, capital structure, the approval of underwriting agreements and advisory agreements, the making of distributions to investors, custody of assets, and codes of ethics.²⁰ Like external advisers to

¹⁹ By way of example, for the last twelve consecutive quarters, every valid redemption request from a stockholder of a Franklin Square sponsored fund has been fully honored.

²⁰ The following provisions of the 1940 Act apply to both registered investment companies and traded and non-traded BDCs: Sections 1, 2, 3, 4, 5, 6, 9, 10(f), 15 (a), (c) and (f), 16(b), 17(f) through (j), 19(a), 20(b), 32 (a) and (c), 33 through 47, and 49 through 53. Sections 12, 18, 21, 23, 31, and 48 are also made applicable to BDCs pursuant to Sections 60 through 65, respectively, with modifications. Certain 1940 Act regulations that apply to registered investment companies, such as limitations on transactions with downstream affiliates (*i.e.*, portfolio companies) and

registered investment companies, external advisers to BDCs must register with the SEC under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), which imposes a statutory fiduciary duty on BDC advisers to act in the best interest of the BDC and, by extension, its shareholders – including retirement plan investors. The 1980 Amendments also introduced a number of additional regulations that apply only to BDCs.²¹ In addition, unlike registered investment companies, BDCs must comply with the corporate governance and other provisions of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”).

Federal regulatory authority also imposes independence and corporate governance requirements on non-traded BDCs. The 1940 Act requires that at least a majority of a BDC’s board of directors be comprised of persons who are independent (*i.e.*, not “interested persons” as defined in Section 2(a)(19) of the 1940 Act).²² In addition, the 1940 Act requires that any investment adviser, principal underwriter and independent registered public accounting firm of a BDC be selected, and reapproved on an annual basis, by a majority of the independent members of the BDC’s board of directors. BDCs are also subject to the independence requirements of the Sarbanes-Oxley Act, including requirements that all BDCs have an audit committee comprised exclusively of independent directors, and that the audit committee (1) appoints the BDC’s independent registered public accounting firm, (2) reviews and approves the BDC’s financial statements and (3) monitors and assesses the BDC’s internal control over financial reporting.²³

Finally, non-traded BDCs are also required to adopt and implement policies and procedures designed to prevent violations of the federal securities laws, review these policies and procedures annually for their accuracy and effectiveness, and appoint a chief compliance officer to administer the BDC’s compliance policies and procedures. The board of directors is tasked with reviewing and approving, generally on an annual basis, any investment advisory agreement, valuation policies, compliance policies, codes of ethics, and other corporate governance procedures applicable to the BDC and its investment advisers. These requirements are designed to require independent directors to review and approve the BDC’s material policies and procedures regularly, including the methodology and related policies and procedures for valuing the BDC’s investment portfolio. The SEC ensures compliance with these requirements through periodic examinations of both the BDC and the BDC’s investment advisers.²⁴

asset coverage, were modified by the 1980 Amendments as they apply to BDCs for the purpose of advancing the mission of BDCs to enhance capital formation for small and developing U.S. companies. For example, see Sections 57 (affiliated transactions) and 61 (capital structure) of the 1940 Act.

²¹ Sections 54 through 65 were added to the 1940 Act by the 1980 Amendments, and are specific to BDCs. These 11 sections contain meaningful investor protections, such as Section 56 (requiring a majority independent board of directors) and Section 57 (prohibiting certain affiliated transactions).

²² Section 56 of the 1940 Act.

²³ 15 U.S.C. § 80a-55 (2012) (regarding director independence); *id.* § 80a-15(a)(2) (regarding investment advisers and underwriters); *id.* § 78j-1 (regarding audit requirements).

²⁴ *Id.* § 80a-37, *see also* 17 C.F.R. § 270.38a-1 (2014) (requiring the adoption of compliance procedures and practices); *see* 15 U.S.C. §§ 80a-15(a), (c) (regarding investment advisory contracts), 17 C.F.R. § 270.38a-1 (regarding compliance policies); *see* 17 C.F.R. § 270.17j-1 (regarding codes of ethics). Though there are no specific requirements

Taken together with the disclosure requirements discussed above, these federal regulations make non-traded BDCs one of the most highly-regulated types of investment vehicles available to investors today.

b) State Regulation Currently Imposes Additional and Substantial Requirements on Non-Traded BDCs.

Non-traded BDCs also are subject to state regulatory oversight and requirements not imposed on registered investment companies and traded BDCs. Non-traded BDCs must comply with state “Blue Sky” laws, meaning that they must additionally register their securities offerings under the securities acts of each state in which they intend to offer securities for sale. Exchange-traded BDCs and registered investment companies are “covered securities” under Section 18 of the Securities Act, which preempts state registration authority and relieves these funds from an important additional layer of regulatory oversight and investor protection. Non-traded BDCs, however, are not “covered securities” and, therefore, must comply with the securities laws and regulations of all fifty states.

In many respects, state securities regulation is more stringent than the federal securities laws. Most states have adopted a version of the Uniform Securities Act, which grants state securities regulators merit review authority, while the federal securities laws grant the SEC only disclosure review authority.²⁵ This difference is significant. Under the SEC’s disclosure review regime, the SEC is only empowered to assess the adequacy of an issuer’s disclosure. In contrast, under the merit review regime that applies to non-traded BDCs – but not other qualified “Assets” – state securities regulators are empowered to consider not only disclosure, but also the underlying merits of the terms of a securities offering, the rights and obligations of a particular security, and even aspects of the issuer’s organizational structure. For example, the Uniform Securities Act grants state regulators the broad authority to deny, suspend, or revoke a securities offering if it finds that “the offering is being made on terms that are unfair, unjust or inequitable.”²⁶

Additionally, many non-traded BDCs must comply with fiduciary requirements and other investor protections under existing state regulations. In exercising their merit review authority, state regulators apply statements of policy adopted by the North American Securities Administrators Association (“NASAA”), whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada, and Mexico. Non-traded BDCs are subject to the NASAA Omnibus Guidelines, which impose a fiduciary duty on non-traded BDC directors, sponsors, and advisers to act in the best interest of the BDC and its shareholders – including retirement plan investors. The NASAA Omnibus Guidelines, among other things, also set caps on certain fees and expenses, prohibit certain conflicts of interest, restrict affiliated transactions, ensure shareholder voting rights, and

for valuation or corporate governance policies, Rule 38a-1 contains general requirements regarding the adoption and implementation of written policies. 17 C.F.R. § 270.38a-1.

²⁵ A majority of states have adopted or modeled their securities act on either the Uniform Securities Act of 1956, as amended, or the Uniform Securities Act of 2002, as amended.

²⁶ Section 306(2)(E) of the Uniform Securities Act of 1956.



establish suitability standards for non-traded BDC investors. For example, to be eligible to invest in a non-traded BDC, an investor generally must have a minimum annual gross income of \$70,000 and a minimum net worth of \$70,000; or a minimum net worth of \$250,000, exclusive of home, home furnishings, and automobiles.²⁷ State regulators are free to increase these minimum eligibility thresholds, and often do. Many states additionally limit an investor's portfolio allocation to non-traded direct participation programs ("DPP").²⁸

Although not the focus of this letter, Franklin Square observes that some aspects of the Proposed Regulation, while consistent in principle with the NASAA Guidelines and some state regulations, might effectively preempt the states' ability to regulate non-traded securities, such as non-traded BDCs, that are commonly held in IRAs. We suggest that the Department, as it moves forward with this rulemaking, consult with NASAA and the various state regulators, as it deems appropriate, concerning any potential preemptive impact of the Proposed Regulation.

c) FINRA Regulation Provides an Additional Layer of Protection for Investors.

Broker-dealers that distribute non-traded BDC securities are regulated by FINRA, which provides an additional layer of protection for investors. Broker-dealers are subject to FINRA licensing, registration and continuing education requirements.²⁹ In addition, broker-dealers are subject to numerous sales practice obligations under FINRA rules, such as investor suitability standards, to protect investors participating in offerings of non-traded BDC securities.

FINRA's suitability rule is "fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct."³⁰ The rule requires a broker-dealer or associated person to:

...have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the [broker-dealer] or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and

²⁷ NASAA Omnibus Guideline III.B.

²⁸ See, e.g., Peter M. Fass & Derek A. Wittner, *Securities Law Handbook Series: Blue Sky Practice For Public and Private Direct Participation Offerings* § 2.2 (2013) (identifying the following states as imposing concentration limits: California, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Missouri, Nebraska, Ohio, Oregon, Pennsylvania, and Tennessee).

²⁹ See U.S. Securities and Exchange Commission Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (January 2011) at 136-38 ("IA/BD SEC Staff Study").

³⁰ FINRA Rule 2111.01.



any other information the customer may disclose to the [broker-dealer] or associated person in connection with such recommendation.³¹

In addition, numerous cases, FINRA guidance, and the IA/BD SEC Staff Study require and/or state that “a broker’s recommendations must be consistent with his customers’ best interests.”³²

Furthermore, FINRA’s DPP rule, which applies to non-traded BDCs, requires broker-dealers that participate in a public offering of a non-traded BDC to, among other things, meet certain requirements regarding underwriting compensation, fees and expenses; perform due diligence on the non-traded BDC; follow specific guidelines on suitability; and adhere to limits on non-cash compensation.³³ In addition, FINRA’s corporate financing rule requires broker-dealers to file with FINRA information about the public offering of non-traded BDC securities.³⁴ FINRA staff reviews the filings and issues a “no objections” opinion if the terms and arrangements governing the broker-dealer’s participation in the offering, and its disclosure of the terms of such participation, appear to comply with the DPP rule’s requirements.³⁵ A broker-dealer must receive a “no objections” opinion before it participates in a distribution of non-traded BDC securities.

FINRA’s “communications with the public” rule provides standards for broker-dealer communications with investors, such as advertisements.³⁶ The rule generally requires, among other things, that communications be fair and balanced with no material omissions that would cause the communication to mislead, and generally bans the use of predictions or projections.³⁷ In addition, the rule requires broker-dealers to file retail communications³⁸ regarding non-traded BDCs with FINRA for review within 10 business days of first use or publication.³⁹

This additional layer of oversight added by FINRA, combined with the state and federal securities regulations, mandatory disclosures and investor protections discussed above, make non-traded BDCs substantially more transparent and highly-regulated than many of the investments currently included on the Department’s proposed list of “Assets.”

³¹ FINRA Rule 2111(a).

³² See *Raghavan Sathianathan*, Exchange Act Rel. No. 54722, 2006 SEC LEXIS 2572, at *21 (Nov. 8, 2006); *Scott Epstein*, Exchange Act Rel. No. 59328, 2009 SEC LEXIS 217, at *40 n.24 (Jan. 30, 2009); *Dane S. Faber*, 57 S.E.C. 297, 310, 2004 SEC LEXIS 277, at *23-24 (2004); *Wendell D. Belden*, 56 S.E.C. 496, 503, 2003 SEC LEXIS 1154, at *10-11 (2003); *Daniel R. Howard*, 55 S.E.C. 1096, 1100, 2002 SEC LEXIS 1909, at *5-6 (2002); *FINRA Regulatory Notice 12-25* (May 2012) at 3; IA/BD SEC Staff Study at 59.

³³ See FINRA Rule 2310. FINRA Rule 2310(a)(4) defines a DPP as a program which provides for flow-through tax treatment. As programs that provide for flow-through tax treatment, non-traded BDCs are subject to the rule.

³⁴ See FINRA Rule 5110(b)(1).

³⁵ See FINRA Regulatory Notice 12-22 (April 2012) at 2.

³⁶ See FINRA Rule 2210.

³⁷ See FINRA Rule 2210(d).

³⁸ “Retail communication” means any written (including electronic) communication that is distributed or made available to more than 25 retail investors within any 30 calendar-day period. See FINRA Rule 2210(a)(5).

³⁹ See FINRA Rule 2210(c)(3)(B).

3. BDCs are Key Middle-Market Lenders and Help Foster U.S. Job Growth.

While the focus of the Department in promulgating the Proposed Regulation is to protect investors, Franklin Square does believe it is important to understand the broader capital markets implications of the proposal. To this point, by omitting non-traded BDCs, the Proposed Exemption may have the practical effect of limiting access to capital for job-creating small and middle-market businesses.

In addition to providing mainstream investors with access to investments historically reserved for wealthy individuals and institutional investors, BDCs provide significant capital to U.S. businesses. While BDCs are an increasingly important source of capital for small businesses, they are becoming a critical source of capital for middle-market businesses as well.⁴⁰ For example, at Franklin Square, because of our scale, our funds primarily invest in the middle-market, which is an increasingly important part of the American economy as we emerge from the Great Recession.

Nearly 200,000 U.S. businesses comprise the middle-market, which translates into one-third of America's private sector gross domestic product.⁴¹ Middle-market businesses employ more than 47 million people,⁴² or one out of every three workers in the private sector.⁴³

Like all firms, middle-market companies were deeply affected by the Great Recession. Nonetheless, they outperformed larger firms in recent years by adding over 2 million jobs,⁴⁴ demonstrating the resiliency of the sector and its importance to the overall health of the U.S. economy.⁴⁵ According to a recent report by American Express and Dun & Bradstreet, middle-market firms, which the report defined as those firms with revenue between \$10 million and \$1 billion, created 2.1 million of the 2.3 million net new jobs added to the U.S. economy between 2008 and 2014.⁴⁶ Middle-market firms generated a 4.4% expansion in employment, versus a 1.6% expansion in big business employment and a 0.9% decline in small business employment over the same period.⁴⁷

Middle-market firms are the new engines of the U.S. economy and are at the forefront of U.S. job growth. Over the last year, the middle-market reported a mean total revenue growth of 7.4% compared to a 2.9% growth rate for the S&P 500 for the same period.⁴⁸ In turn, the demand for capital among middle-market companies is still increasing. In its most recent middle-market

⁴⁰ The National Center for the Middle Market defines middle-market businesses as businesses with revenues between \$10 million and \$1 billion. *See*, 1Q 2015, Middle Market Indicator.

⁴¹ 1Q 2015 Middle Market Indicator, National Center for the Middle Market.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Middle Market Power Index, April 2015, American Express Global Corporate Payments and Dun & Bradstreet.

⁴⁷ *Id.*

⁴⁸ 1Q 2015 Middle Market Indicator, National Center for the Middle Market.



indicator survey, the National Center for the Middle Market reported that 39% of middle-market companies expect to add more jobs in 2015.⁴⁹ The National Center for the Middle Market estimates this will translate into another 5.3% revenue expansion across U.S. middle-market firms over the next year.⁵⁰ Middle-market lenders, like BDCs, must be positioned to provide the capital necessary to fuel this anticipated growth.

As banks faltered during the financial crisis and cut back on middle-market lending, BDCs stepped into the breach to provide much-needed capital. Since the beginning of the economic downturn in 2008 and 2009, the value of BDC loans in the marketplace has more than tripled.⁵¹ Currently, BDCs have over \$70 billion in outstanding loans, a significant portion of which have been made to middle-market firms.⁵² Franklin Square's BDCs have deployed more than \$27 billion alone, primarily to U.S. middle-market companies. With the mandate of investing at least 70% of their total assets in U.S. small-cap and private companies, BDCs are uniquely positioned to continue to provide the capital desperately needed by middle-market firms to fuel growth and create jobs. Including non-traded BDCs in the Proposed Exemption would augment the role of BDCs in the capital markets.

CONCLUSION

For the reasons discussed above, Franklin Square respectfully requests that the Department amend the Proposed Exemption to include non-traded BDCs on the list "Assets." We believe this change is consistent with the objectives of the Proposed Regulation for two reasons. First, non-traded BDCs offer investment opportunities that meet the standards set forth in the Proposed Exemption's preamble. In particular, non-traded BDCs: are subject to robust disclosure requirements that collectively provide investors a high level of transparency; are designed to be less correlated with the stock market and, therefore, an important part of a well-diversified portfolio; have a ready market price; and offer investment horizons that are designed to provide liquidity over time.

Second, non-traded BDCs are among the most highly-regulated investment vehicles in the marketplace, subject to numerous regulatory regimes, including the 1940 Act, the Securities Act, Exchange Act, the state securities acts of all 50 states and the District of Columbia, and rules administered by FINRA. We believe that the regulatory framework for non-traded BDCs provides investors with more protection than those regimes associated with many other types of investments currently on the Department's proposed list of "Assets."

Finally, consistent with the Department's broader job creation goals, Franklin Square also believes that inclusion of non-traded BDCs within the proposed definition of "Assets" will support job creation for small and middle-market American businesses by increasing the flow of capital to these firms.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ Small Business Investor Alliance: BDC Modernization Agenda, with data from Wells Fargo Securities, LLC.

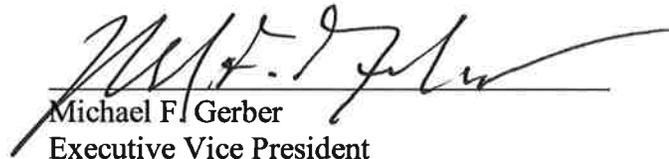
⁵² *Id.*



Franklin Square strongly supports the goals of the Proposed Regulation and we believe that having a robust Proposed Regulation in place, coupled with a workable Proposed Exemption that includes non-traded BDCs, will protect American investors while allowing them to participate in these diversified, transparent, highly-regulated investment vehicles that are key to the growth of America's middle class.

Franklin Square appreciates the opportunity to comment on the Proposed Exemption. Please feel free to contact me at 215-220-4525 with any questions about this submission.

Sincerely,



Michael F. Gerber
Executive Vice President
Franklin Square Holdings, L.P.