

September 24, 2015

**VIA ELECTRONIC MAIL TO: E-ORI@DOL.GOV; E-OED@DOL.GOV**

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:

Thank you for the opportunity to testify on August 13, 2015 on behalf of Franklin Square Holdings, L.P. (“Franklin Square”) concerning the proposed regulation regarding conflicts of interest in retirement investment advice (the “Proposed Regulation”) and the above-referenced Proposed Best Interest Contract Exemption (the “Proposed Exemption”). As discussed in my testimony and in our written comment, Franklin Square shares the Department of Labor’s (the “Department”) goal of protecting plans, participants, beneficiaries, and IRA owners and applauds the care and thoughtfulness that went into the development of the Proposed Regulation and Proposed Exemption. In support of this goal and the Department’s efforts, we requested that the Department expand the definition of “Asset” covered by the Proposed Exemption to include non-traded business development companies (“BDCs”) with narrowly tailored language that would otherwise leave the Proposed Exemption intact.

I offer this letter as a follow up to questions that were asked at the hearing. Those questions related to the kinds of investors who invest in non-traded BDCs, protections presently enjoyed by investors in non-traded BDCs, and additional protections that could be afforded to investors in non-traded BDCs. In response to those questions, this letter provides the following:

1. A summary of our request, which is simply to replace the phrase “registered investment companies” with the phrase “investment companies regulated pursuant to the Investment Company Act of 1940” in the Proposed Exemption’s definition of “Asset.” This change would add non-traded BDCs to the list of “Assets” covered by the Proposed Exemption but would not include investment products that are not regulated under the Investment Company Act of 1940, as amended (the “1940 Act”), such as non-traded real estate investment trusts (“REITs”), master limited partnerships (“MLPs”), public and private oil and gas funds, and equipment leasing funds.

2. An overview of the regulatory regime applicable to non-traded BDCs, focusing on the protections that would be afforded to investors in non-traded BDCs by the Proposed Exemption and the 1940 Act if the Department adopts our request.
3. An explanation of additional protections that Franklin Square provides the investors in its non-traded BDCs that could be added to the Proposed Exemption to ensure investors have access only to those non-traded BDCs that offer best-in-class protections.

## **I. Summary of Franklin Square's Request**

As explained more fully in my testimony and in our written comment, we have proposed replacing the phrase “registered investment companies” with the phrase “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. . . .

This change would add non-traded BDCs to the list of “Assets” covered by the Proposed Exemption because non-traded BDCs are regulated under the 1940 Act – like registered investment companies. It would not capture other kinds of investments that sometimes are perceived to be similar to non-traded BDCs but are not regulated under the 1940 Act – such as non-traded REITs, MLPs, public and private oil and gas funds, and equipment leasing funds. The change would not remove from the definition of “Asset” any investment opportunity already included nor impact the Proposed Exemption in any other way.

## **II. Franklin Square's Proposal Includes Heightened Investor Protections**

As discussed in our comment letter and at the hearing, non-traded BDCs are subject to an extensive regulatory regime that protects investors. We respectfully submit that these protections, combined with ERISA's fiduciary rules and the requirements of the Proposed Exemption, would provide ample protection for investors:

**1. Franklin Square's Proposal is consistent with the framework of the Proposed Exemption.** The premise of the Proposed Exemption is that a recommendation to invest in a non-traded BDC would be subject to ERISA's fiduciary standard. Under the current proposal,

this means that an adviser, relying on the Proposed Exemption, would have to make an informed decision that an investment in a non-traded BDC is in the “best interest” of his or her client, in light of the client’s investment objectives, risk tolerance, financial circumstances, and needs.

The fiduciary standard would prohibit an adviser from recommending an investment in a non-traded BDC when it is inappropriate under the circumstances. For example, an adviser may conclude that an investment in a non-traded BDC is advisable for a client with a longer-term investment horizon who is seeking to diversify his or her portfolio with an investment that is less correlated to the public equity markets, or for a client who is retired and wants to protect his or her principal while generating above average current income. By contrast, a non-traded BDC investment might not be advisable for a client who has a short-term investment horizon, has no need for capital protection or current income, or has immediate or significant liquidity needs.

We simply request that the decision regarding whether to recommend an investment in a non-traded BDC be left to the adviser in the exercise of his or her fiduciary judgment and pursuant to the other terms of the Best Interest Contract.

**2. Existing federal legal protections provide a broad array of safeguards for non-traded BDC investors.** Non-traded BDCs currently are subject to an extensive regulatory regime that protects investors by imposing, *inter alia*, robust disclosure and transparency requirements, valuation requirements, and duties of care. As detailed in our written comment letter, non-traded BDCs are regulated by at least as many, if not more, regulators and regulatory regimes as all of the investments already included in the definition of “Asset.” The attached chart summarizes these protections afforded by federal and state laws and regulations.

**3. State legal protections establish minimum eligibility thresholds for investing in non-traded BDCs.** Regulations in all 50 states impose preconditions for investing in non-traded BDCs. Although state rules vary, all states maintain at least the following minimum requirements:

- Investors must have a minimum annual gross income of \$70,000 and a minimum net worth (excluding home, home furnishings and automobiles) of \$70,000; or
- Investors must have a minimum net worth (excluding home, home furnishings and automobiles) of \$250,000.<sup>1</sup>

Additionally, many states routinely increase these minimum eligibility thresholds for investing in non-traded BDCs.

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In sum, we have requested only to include non-traded BDCs on the list of investment choices that fiduciary advisers may recommend under the Proposed Exemption. We are not requesting exemptions from the fiduciary standard or any other ERISA requirement. To the

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<sup>1</sup> NASAA Omnibus Guideline III.B.

contrary, any recommendation to invest in a non-traded BDC would be subject to ERISA's fiduciary standard – which requires careful analysis of the investor's needs and interests. In light of the existing regulatory regime and ERISA's fiduciary standard, we believe it is appropriate to include non-traded BDCs on the list of "Assets" covered by the Proposed Exemption.

### **III. Franklin Square's Best Practices Offer Further Investor Protections**

In addition to the substantial protections offered under current law, Franklin Square's best practices afford the following heightened investor protections:

**1. Enhanced Valuation and Transparency.** The 1940 Act requires that a non-traded BDC value 100% of its assets annually, in a process overseen by the non-traded BDC's board of directors, the majority of whom are independent. The industry standard is to value 25% of a fund's assets every quarter – which results in valuing 100% of the assets every year. Franklin Square goes two steps further. First, while not required under the law, each of Franklin Square's non-traded BDCs use independent third-party pricing and valuation services to determine fair value, which is then considered and approved by the non-traded BDCs' independent boards. Second, the independent boards value 100% of the assets in each of Franklin Square's non-traded BDCs *every quarter*.

Franklin Square BDCs constantly monitor their portfolio holdings to ensure compliance with the 1940 Act prohibition against selling shares at a price below net asset value ("NAV") per share. Franklin Square's third-party pricing and valuation services provide each BDC's board with a daily and weekly estimated NAV per share, and have the ability to conduct an intra-quarter valuation in the event of a material change in the value of one of the BDC's investments. The valuation of each investment held in a Franklin Square BDC's portfolio is communicated to investors and the market at least quarterly on a schedule of investments included in mandatory SEC filings.

**2. No Over-Distribution.** Franklin Square's non-traded BDCs make distributions to shareholders only from net investment income, proceeds from the sale of assets, and dividends and other distributions from portfolio companies. Franklin Square's non-traded BDCs do not pay distributions to shareholders from offering proceeds or borrowings. Moreover, Franklin Square has agreed to reimburse its non-traded BDCs for expenses in sufficient amounts to ensure that no portion of any distributions to shareholders are paid from offering proceeds or borrowings. This presents a stark contrast between Franklin Square's non-traded BDCs and most other non-traded investment vehicles in the marketplace, such as non-traded REITs. Again, this Franklin Square practice is not required by law but is something we do in our effort to offer best-in-class protections to our investors.

**3. Fair Value Redemptions.** Franklin Square's non-traded BDCs offer a measure of liquidity to their shareholders by offering to repurchase a number of shares each calendar year equal to 10% of the weighted average number of shares outstanding in the prior calendar year, at a rate of 2.5% per quarter. For Franklin Square's non-traded BDCs that are offering shares to

new investors, the repurchase price is the price of shares offered to the public, net of any sales commissions or dealer manager fees that were charged to the investor. For Franklin Square's non-traded BDCs that have closed to new investors, the repurchase price is the price at which shares are issued under the funds' distribution reinvestment plans. Importantly, limiting liquidity in some way significantly contributes to a non-traded BDCs' lower correlation to trading markets. This is a key differentiating feature of non-traded BDCs that makes them attractive to diversification-seeking investors.

**4. Sponsor Investment.** Franklin Square and its affiliates believe in Franklin Square's funds and collectively have invested approximately \$148 million across all of its funds as of August, 2015. This level of sponsor commitment far exceeds the industry standard. For example, non-traded REIT sponsors typically invest only \$200,000 in a new REIT as an initial investment, which amounts to just 0.01% of a \$2 billion offering. Our level of voluntary sponsor investment shows Franklin Square is committed to the long-term success of its funds and, most importantly, aligns its interests with those of its investors.

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Franklin Square appreciates the opportunity to provide this letter in response to the Department's questions. Please feel free to contact me at 215-220-4525 with any questions about this submission.

Sincerely,



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

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<b>Public Filings</b>	BDCs <sup>1</sup> must register their securities under the Securities Act of 1933, as amended (the “Securities Act”), which requires extensive disclosures regarding, among other things, the BDC, the securities offered, the BDC’s investment objectives and strategies, risk factors and financial condition.	BDCs are required to register a class of securities under the Securities Act of 1934, as amended (the “Exchange Act”), and, as such, are required to file periodic and other reports with the Securities and Exchange Commission (the “SEC”), including proxy statements and Forms 10-Q, 10-K and 8-K.	BDCs are regulated under the Investment Company Act of 1940, as amended (the “1940 Act”) and, as such, are required to file certain additional reports with the SEC, including fidelity bond filings.	Non-traded BDCs must register their securities offerings under the securities acts of each state in which they intend to offer securities for sale. <sup>2</sup>	
<b>Valuation and Pricing</b>		The Exchange Act requires that the valuation of a BDC’s portfolio holdings be	The 1940 Act requires BDCs’ independent boards of directors to		As part of their best practices, each of Franklin Square’s BDCs has its

<sup>1</sup> Except as otherwise provided, references to “BDCs” in this chart include both traded and non-traded business development companies.

<sup>2</sup> A majority of states have adopted or modeled their securities acts on either the Uniform Securities Act of 1956, as amended, or the Uniform Securities Act of 2002, as amended. The Uniform Securities Act grants state securities regulators merit review authority, while the federal securities laws grant the SEC only disclosure review authority. 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 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.”

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<p><b>Valuation and Pricing (continued)</b></p>		<p>publicly disclosed to investors and the market at least quarterly on SEC Forms 10-Q and 10-K, significantly enhancing the transparency of BDCs.</p>	<p>determine the fair value of the BDCs’ portfolio holdings at least quarterly and to revise the BDCs net asset value and share price to ensure that shares are not sold at a price below net asset value. In doing so, BDCs’ share prices fluctuate to take into account the current market value of their underlying assets.</p>		<p>portfolio valuations conducted by independent third-parties, approved by the valuation committee and then approved by the full independent board. While many BDCs value 25% of their assets each quarter, each of Franklin Square’s BDCs values 100% of its assets each quarter.</p> <p>REITs and other direct participation programs (“DPPs”) are not required to perform or disclose portfolio valuations at all while offering securities to new investors and for a period of time thereafter.</p>

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<p><b>Limitations on Distributions</b></p>			<p>The 1940 Act permits BDC distributions to be paid from offering proceeds or borrowings, so long as investors are informed of the sources of the BDC’s distributions.</p> <p>Because the 1940 Act does not apply to REITs, REIT distributions can be paid from investor proceeds or borrowings without notice to investors.</p>		<p>As part of their best practices, Franklin Square’s BDCs do not engage in over-distribution and Franklin Square has committed that the funds it sponsors will not pay distributions from offering proceeds or borrowings.</p> <p>REITs routinely over-distribute (<i>i.e.</i>, pay distributions to investors from investor proceeds and/or borrowings).</p>
<p><b>Limitations on Affiliated Transactions</b></p>			<p>The 1940 Act contains substantial restrictions on a BDCs ability to engage in transactions with its affiliates, which include its officers, directors and their</p>	<p>The NASAA Omnibus Guidelines provide another layer of restrictions on non-traded BDCs’ ability to engage in affiliated transactions.</p>	

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<p><b>Limitations on Affiliated Transactions (continued)</b></p>			<p>respective affiliates. These restrictions include prohibitions on co-investment with entities affiliated with the BDC’s investment adviser or sub-adviser, unless price is the only negotiated term. Additional limitations are applicable to investment advisers and sub-advisers to BDCs under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).</p>	<p>REITs are only limited in their ability to engage in affiliated transactions by the more permissive NASAA REIT Guidelines.</p>	
<p><b>Investment Diversification</b></p>			<p>The 1940 Act requires BDCs to invest at least 70% of their total assets in “eligible portfolio companies,” which generally means U.S. private operating companies, public non-traded U.S.</p>		<p>In addition to being able to provide investors with a more diversified portfolio, each of Franklin Square’s BDCs utilizes a conservative approach to investing. Franklin</p>

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<p><b>Investment Diversification (continued)</b></p>			<p>operating companies and publicly-traded operating companies with less than \$250 million in market capitalization. Within this general requirement, there are limited other restrictions on the types of investments BDCs may make, meaning that BDCs generally may invest across all industry sectors and at all levels of a portfolio company’s capital structure. Additionally, the Internal Revenue Code of 1986, as amended (the “Code”), requires entities electing to be treated as regulated investment companies, such as most BDCs, to maintain minimum diversification</p>		<p>Square’s BDCs primarily make senior secured loans to U.S. middle market companies. Senior secured loans (first and second lien loans) sit at the top of a portfolio company’s capital structure and are secured by assets of the company. This means that in the event of bankruptcy or liquidation of the portfolio company, Franklin Square’s BDCs are repaid before junior creditors and equity holders of the portfolio company. Investing primarily in senior secured loans reduces the exposure of Franklin Square’s BDC investors to credit risk.</p>

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<b>Investment Diversification (continued)</b>			<p>standards within their portfolios.</p> <p>On the other hand, the Code requires REITs to hold a minimum of 75% of their assets in “qualifying real estate investments,” such as real property, mortgages secured by real property and real estate related securities. As a result, BDCs are able to assemble highly diversified portfolios while REITs and other DPPs, such as equipment leasing programs, oil &amp; gas drilling programs and master limited partnerships, are not.</p>		

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<b>Independence<sup>3</sup></b>			<p>The 1940 Act requires that at least a majority of a BDC’s board of directors be comprised of persons who are independent (<i>i.e.</i>, not “interested persons,” as defined in Section 2(a)(19) of the 1940 Act). The 1940 Act also 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.</p>		<p>As indicated above, as part of their best practices, each of Franklin Square’s BDCs has its portfolio valuations conducted by independent third-parties, approved by the valuation committee and then approved by the full independent board.</p>

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<sup>3</sup> BDCs are also subject to the independence requirements of the Sarbanes-Oxley Act of 2002, 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.

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<b>Duties of Care</b>			<p>Like external advisers to registered investment companies, external advisers to BDCs must register with the SEC under 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.</p> <p>REIT Advisers generally are not subject to the Advisers Act.</p>	<p>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 and ensure shareholder voting rights.</p>	
<b>Minimum Eligibility Thresholds</b>				<p>Regulations in all 50 states impose pre-conditions for investing in non-traded BDCs in the form of minimum</p>	

# Investor Protections for BDCs

Requirement	Securities Act of 1933	Securities Exchange Act of 1934	Investment Company Act of 1940	State “Blue Sky” Laws	Franklin Square Best Practices
<b>Minimum Eligibility Thresholds (continued)</b>				<p>eligibility thresholds. 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 (excluding home, home furnishings and automobiles) of \$70,000; or a minimum net worth (excluding home, home furnishings and automobiles) of \$250,000. State regulators often increase these minimum thresholds. Many states also limit investor portfolio allocations to non-traded BDCs.</p>	