Issue Brief – Proposed BDC deregulation

Bill would shift credit away from small businesses, to hedge funds and other Wall Street vehicles

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Key points:

- **Business Development Companies (BDCs) were designed to inject capital into small and mid-size companies. BDCs are currently required to invest at least 70% of their capital into small businesses.**
- **As an incentive to invest, BDCs are not required to pay corporate income tax.**
- **The so-called "Small Business Credit Availability Act" would permit BDCs to shift their investment focus away from small and medium-sized businesses and into much more risky financial service companies, such as hedge funds and other alternative investments.**
- **The proposed legislation would let BDCs become even more risky by allowing them to take on twice as much leverage.**
- **The "Small Business Credit Availability Act" is being funded by not-so-small business—including Ares Management, a $94 billion dollar alternative asset manager.**
- **Through its BDC, Ares Capital Corporation, the company has spent approximately $1.44 million between 2012 and 2015 to lobby Congress on BDCs, with $360,000 spent in lobbying efforts in just the past year.**
- **The bill would be a gift to Ares Capital – as of the end of 2015 the firm was nearly 30% invested in "investment funds" and "financial services", based on an analyst report.**

On Thursday, May 19, 2016 the Securities, Insurance, and Investment Subcomittee of the Senate Banking Committee will hold a hearing regarding proposed deregulation of Business Development Companies (BDCs).

In November 2015, the House Financial Services Committee voted for the innocuously named "Small Business Credit Availability Act", (H.R. 3868), sending the bill to the House floor.[1]

Rather than making it easier for small businesses to get loans, though, the bill would let tax-advantaged entities called Business Development Companies (BDCs) shift their focus away from small businesses and nearly double their investments in hedge funds and other Wall Street financial vehicles.[2]

BDCs, established by Congress in 1980, are investment vehicles that were designed to inject capital into small and mid-size companies. As an incentive to invest, BDCs are not required to pay corporate income tax.[3]

Between 2003 and June 30, 2015, BDCs have grown tenfold from managing $5 billion to $52.3 billion. [4] Under current law, BDCs must invest at least 70% of their capital into small and medium size companies.[5]

However, the "Small Business Credit Availability Act" would permit BDCs to shift their investment focus away from small and medium-sized businesses and into much more risky financial service companies, such as hedge funds and other alternative investments. The bill would allow BDCs to nearly double their investments in hedge funds and other risky vehicles by cutting the threshold that BDCs must invest in small businesses to 50%.[67]

US Securities and Exchange Commission (SEC) Chair Mary Jo White stated in a November 2015 letter to the House Financial Services Committee that:

> "The explicit exclusion of financial institutions from the definition of "eligible portfolio company" in the Act was intended to encourage BDCs to focus their investment activities on operating companies that directly produce goods or produce services rather than on other financial institutions that serve primarily as conduits of capital… In my view the proposed amendments likely would result in a diversion of capital from small, growing businesses that BDCs were originally created to help.'[8]

All this and BDCs would still maintain their corporate income tax break.

In addition to allowing BDCs to invest more in risky investments like hedge funds, the proposed legislation would let BDCs become even more risky by allowing them to take on twice as much leverage.[9]

A. Heath Abshure, past president of the North American Securities Administrators Association (NASAA) and former Arkansas Securities Commissioner raised concern about this provision in testimony delivered to the House Financial Services Committee on a similar bill in 2013, noting that:

> "Excessive leverage by some of our largest financial institutions...was at least part of the problem we faced as part of the most recent financial crisis and many other crises before it."[10]

Interestingly, the "Small Business Credit Availability Act" is being funded by not-so-small business—including Ares Management, a $94 billion dollar alternative asset manager.[11] Through its BDC, Ares Capital Corporation, the company has spent approximately $1.44 million between 2012 and 2015 to lobby Congress on BDCs, with $360,000 spent in lobbying efforts in just the past year.[12]

The bill would be a gift to Ares Capital – as of the end of 2015 the firm was nearly 30% invested in "investment funds" and "financial services", based on an analyst report.[13]

Despite caution from the SEC and others, the House Financial Services Committee voted in favor of this legislation even though it is poses a threat to small businesses and retail investors alike.

Small and medium-sized businesses are the bedrock of our economy. Now more than ever, these businesses need credit to grow and create jobs. But "The Small Business Credit Availability Act", pushed by Ares Capital, would instead shift BDCs' tax-free investments to risky vehicles like hedge funds.

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1 HR 3868 House Financial Services Committee roll call, Nov 4, 2015.
2 Mary Jo White letter to House Financial Services Committee, Nov 2, 2015.
3 "BDC Modernization Agenda," Small Business Investor Alliance, 2015.
4 "SEC's Mary Jo White rips bill to ease restrictions on BDCs," Investment News, Nov 13, 2015.
5 Mary Jo White letter to House Financial Services Committee, Nov 2, 2015.
6 Mary Jo White letter to House Financial Services Committee, Nov 2, 2015.
7 "SEC's Mary Jo White rips bill to ease restrictions on BDCs," Investment News, Nov 13, 2015.
8 Mary Jo White letter to House Financial Services Committee, Nov 2, 2015.
9 Mary Jo White letter to House Financial Services Committee, Nov 2, 2015.
10 http://www.nasaa.org/27276/legislation-reduce-impediments-capital-formation/
11 https://www.aresmgmt.com/, accessed Apr 5, 2016.
12 Ares Capital lobbying disclosures: 2015(Q1, Q2, Q3, Q4), 2014 (Q1, Q2, Q3, Q4), 2013 (Q1, Q2, Q3, Q4), 2012 (Q1, Q2, Q3, Q4)
13 Based on sector exposure of 21.2% to investment funds and 4.6% to financial services, J.P. Morgan. "Ares Capital: Risks and Opportunities Abound". *North America Equity Research*. 25 February 2016. Pg. 4.