Consumer Federation of America

November 12, 2013

The Honorable Jeb Hensarling
Chairman
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
Financial Services Committee
U.S. House of Representatives
Washington, D.C. 20515

Dear Chairman Hensarling, Ranking Member Waters and members of the committee:

I am writing on behalf of the Consumer Federation of America (CFA) to express our strong opposition to two of the bills that are scheduled to be marked up in full committee Thursday. Like previous bills considered in this committee, H.R. 1800 and the Duffy discussion draft seek to promote capital formation by reducing protections and increasing costs for investors who are the providers of capital. We are writing to urge you to vote no on these ill-conceived, anti-investor bills.

- **Oppose H.R. 1800, which would magnify risks of Business Development Companies.**

Congress created Business Development Companies (BDCs) to invest in, and provide managerial assistance to, small, growing, and financially troubled businesses. Two features of BDCs in particular demand a cautious approach to regulatory changes: 1) their holdings in very small public companies, private companies and struggling businesses make these inherently risky investments; and 2) most shares are held by retail investors. The legislation would magnify BDCs' inherent risks by substantially increasing their ability to use leverage. If the legislation's reduced asset coverage requirement were adopted, for example, all it would take for investors to experience a total loss on their investment would be a one-third drop in asset values. As SEC Chair Mary Jo White noted in her letter to the committee: "The risk that a BDC will be unable to make timely payments to senior security holders is … of particular concern in view of the illiquid types of investments that BDCs make. The asset coverage provisions act as a circuit breaker." This legislation would dramatically reduce its effectiveness.

This problem is exacerbated by the legislation's treatment of preferred stock, which would enable BDCs to increase their permissible debt limits simply by issuing additional preferred stock. As Arkansas Securities Commissioner Heath Abschure noted in his testimony before this committee, "allowing BDCs to issue [unlimited amounts of] preferred stock is inviting them to dilute the value owned by holders of common stock. Moreover, by allowing preferred stock to count on the equity side of the ratio, the effect of the change would be to permit BDCs to issue greater amounts of debt, potentially placing the holders of common shares in a position where they could be wiped out in the event the BDC incurred losses. This would not serve BDC investors well."

Some have suggested that regulatory changes are needed because the "existing regulatory framework has created challenges for BDCs seeking to raise and deploy capital." But the facts suggest otherwise. Assets in BDCs have grown ten-fold over the past decade, from roughly $5 billion in 2003 to more than $53 billion today, with much of the growth coming from new entrants into the market. Meanwhile, regulatory changes such as those proposed here that would significantly increase BDC risks would dramatically reduce the number of shareholders for whom BDCs would be a suitable investment. All it would take would be a few high profile cases in which investors were wiped out because of excessive leverage for BDCs to become too toxic to sell to retail investors. That would bad for investors, bad for BDCs, and bad for capital formation.

- **Oppose the Duffy Discussion Draft, which would inflate costs to retail investors without promoting capital formation.**

CFA strongly opposes the Duffy discussion draft, which would require the SEC to conduct a pilot program to increase tick sizes, and thus trading costs, for equity securities of all but the largest public companies. The SEC clearly already has authority to conduct a pilot program to increase tick sizes, should it choose to do so. The legislation would simply limit the SEC's options in designing such a pilot program and do so in ways that are not in investors' interests. It would, for example, set an overly long five-year timeframe for the pilot project, with no ability to halt the project should it become clear that it imposed costs on investors that exceeded its benefits. It would require eligible companies to opt out of, rather than opting in to, the increased tick sizes. It would apply to large companies that are already actively traded and enjoy significant market maker support, not simply the small, illiquid companies it purports to benefit. And it would do nothing to evaluate whether other alternatives could achieve the same or better results in terms of increased liquidity and capital formation for small companies without artificially inflating trading costs for retail investors. CFA opposes any reversal of decimal pricing. But if the SEC is to conduct a pilot project of this ill-advised policy, it should at least be free to design it in a way that minimizes the risks to retail investors. The Duffy discussion draft does not meet that test.

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We recognize the desire of Congress to adopt policies that promote capital formation, particularly for small companies. But increasing risks and costs for investors, as these bills would do, is not the way to achieve that goal. Thank you for your attention to our concerns. If you have additional questions about our position on these issues you can contact me at (719) 543-9468 or bnroper@comcast.net.

Respectfully submitted,

Barbara Roper
Director of Investor Protection