S. HRG. 114–388

IMPROVING COMMUNITIES' AND BUSINESSES' ACCESS TO CAPITAL AND ECONOMIC DEVELOPMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITIES, INSURANCE, AND INVESTMENT

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING HOW BUSINESS DEVELOPMENT COMPANIES, COMMERCIAL REAL ESTATE FINANCE, AND MARKET MUTUAL FUNDS PROVIDE ACCESS TO CAPITAL AND ECONOMIC DEVELOPMENT FOR COMMUNITIES AND BUSINESSES

MAY 19, 2016

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C O N T E N T S

THURSDAY, MAY 19, 2016

WITNESSES

Additional Material Supplied for the Record

IMPROVING COMMUNITIES' AND BUSINESSES' ACCESS TO CAPITAL AND ECONOMIC DEVELOPMENT

THURSDAY, MAY 19, 2016

U.S. SENATE,
SUBCOMMITTEE ON SECURITIES, INSURANCE, AND INVESTMENT,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. This hearing will come to order.

This morning, the Subcommittee on Securities, Insurance, and Investment is holding a hearing on "Improving Communities' and Businesses' Access to Capital and Economic Development". We want to welcome all of our witnesses here today as well as the Members of the Committee.

I will state at the outset we have a series of votes scheduled at 11:15, so we are probably going to be moving through pretty fast today. I will just give the Senators and the witnesses advance warning of that. And we have had a request from just a couple of our Members to give an opening statement as well as the Chairman and Ranking Member, so I have agreed to that as well, and we will proceed with opening statements by myself, Senator Warner, Senator Toomey, and then Senator Menendez. And then we will move to the witnesses.

Today's hearing will provide insights into how business development companies, commercial real estate finance, and money market mutual funds provide access to capital and economic development for communities and businesses.

There is a growing chorus that pending and existing Federal rules and statutory limitations are restricting access to capital and restraining economic growth.

Because it is important for Congress to understand the factors that are impacting local communities and businesses, I welcome a discussion about specific proposals that would improve the current regulatory framework while maintaining proper safeguards.

The House Financial Services Committee has already examined proposals to modernize the regulations for business development companies and to adjust the risk retention rules for commercial real estate loans.

Senators Toomey and Menendez have introduced legislation to restore the stable share price for institutional, nongovernment money market funds.

I look forward to hearing from our witnesses on these legislative proposals and learning what specific factors, including Federal regulations, are negatively impacting lending and borrowing in local communities, for example:

How a pending regulatory effective date will impact commercial real estate financing since almost $100 billion of loans in commercial mortgage-backed securities are set to mature in 2017, up from $52 billion this year.

What will be the impact on State treasurers to invest and use money market mutual funds when several types of these funds will be required to switch from a stable to a floating net asset value in October?

What statutory changes can be made to allow business development companies to increase investments in small and middle-market companies and enable investors to invest alongside with them and still provide adequate investor protections?

These and a number of other questions I believe will be dealt with today as we discuss these issues, and I will conclude with that and turn to Senator Warner.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Well, thank you, Mr. Chairman, and I apologize for being late. I wish I knew somebody who was involved in Virginia government to get that traffic moving.

[Laughter.]

Senator WARNER. I want to thank you for holding this hearing on the need to improve access to capital for businesses and communities. There is, I think, generally a bipartisan interest that we need to do more in this area, but in a way that is both responsible to avoid harm to investors and the financial system.

I am particularly interested in the legislation to enhance business development company lending. BDCs, as we all know, were originally created by Congress to spur investment in small and middle-market companies, and since the crisis, actually we saw in the *Wall Street Journal* in 2014 that small business lending from the ten largest banks was down 38 percent compared to 2006. Clearly, there is a void that other lenders must fill.

I do have to say in terms of the legislation we are going to be looking at, I harbor some reservations about the House bill since it allows these BDCs to invest further in financial services' assets as opposed to the more traditional funding of what I would call more the "real economy." And I am also concerned about the proposal to codify an exemption to owner registered investment adviser. But I do remain open on the question of how we can better use BDCs.

On the commercial real estate risk retention, I think it is important to remember why we have risk retention rules in the first place. In the aftermath of the crisis, many financial institutions practiced an "originate to distribute" model with mortgage-backed securities displaying little regard for the quality of the underlying asset. This practice saddled investors with highly rate but low-quality assets, spurring large losses.

We know on the residential side we started with a 5-percent risk retention rule. I know there are some questions we are going to be looking at today about potentially lowering those risk retention rules' requirements for certain types of CMBS. I think it is open to that, but I believe it is important to maintain the principle of aligning incentives between the sponsors of securitization and the investors.

I know I have got a couple of my colleagues here who are involved with the legislation dealing with money market funds. In 2014, the SEC came up with what I believe was a compromise in terms of rules, changing the treatment of institutional—and I stress "institutional"—prime money market mutual funds by requiring a floating NAV.

Some of these changes have been controversial, and with market participants, including municipalities, municipalities in my own State, raising concerns about the effect of a floating NAV and the effects that will have on the demand for municipality securities.

In evaluating this rule, though, I think it is helpful for us to revisit the financial crisis and what precipitated the much-needed reform from the SEC. Again, we could go back and reexamine what happened back in 2008 with the Reserve Primary Fund that ended up from Lehman breaking the buck and the runs on the industry at that point. Clearly, there were efforts put in place, temporary at that point, to try to guard against further erosion of an instrument that many municipalities used for liquidity.

I would agree that money market funds are an important cash management tool, but it is important that we never again return to the situation where taxpayers must step in to bail out a private entity. That is why the President's Working Group on Financial Reform, the FSOC, and many Senators urge this panel for the SEC to act in terms of reforming the money market industry. There were a series of proposals that the SEC considered. I believe that where they came down in terms of the floating NAV actually seems to be pretty much in a good spot.

Today we are discussing legislation that would undo some of those safeguards applied to that one-third of the industry within the institutional investors. I remain open to hearing the arguments, but obviously I have a series of grave concerns on this topic.

So, again, Mr. Chairman, I think these are three serious pieces of legislation. They are to some a little bit arcane, but obviously all key to the smooth functioning of our financial markets, and I look forward again to hearing particularly from our colleagues Senator Toomey and Senator Menendez because I know they feel quite strongly on this legislation.

Thank you.

Chairman CRAPO. Thank you, Senator Warner, and I appreciate your thoughts, our working relationship, and will work with you on these issues.

Senator Toomey.

STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thank you, Mr. Chairman and Senator Warner. Thanks for having this hearing.

I think it is clear that the American economy has been underperforming for a number of years now. There are many contributing factors, but one of them, in my view, is the overregulation that has been inflicted on the economy, including in the financial services space.

At today's hearing we are going to look at and examine two somewhat narrow but, nevertheless, important aspects of ways in which excessive regulation can be harmful to economic growth. Money market funds are a critical source of short-term financing in our communities. They are attractive to investors and issuers because they are low cost, they are extremely efficient, they are very liquid, and they are very stable. They offer modest returns, but they offer also very low risk, and that is a suitable combination for many.

The financial crisis absolutely stressed the financial system. We had hundreds of banks and dozens of insurance companies that failed. Money market funds went through that period, and yet only one broke the buck. And investors in that fund recovered 99.1 cents for every dollar they had invested.

Whatever one thinks of the taxpayer guarantees that were imposed during the crisis, the fact is taxpayers never ended up having to shell out a penny for investors in these funds.

Nevertheless, in 2010, the SEC imposed a wave of very, very significant regulations on money market funds, including stringent liquidity requirements, shorter maturities on assets. And then in 2014, without any evidence that the 2010 regulations were inadequate, the SEC, nevertheless, imposed a new set of regulations, including stress testing, diversification requirements, additional disclosures, and requiring prime and tax-exempt institutional money market funds to abandon the $1 stable NAV.

This is problematic for several reasons which we will discuss today. I am grateful to Senators Menendez, Crapo, and Manchin for joining me in legislation that would allow funds to elect a status which would enable money market funds to use the amortized cost and penny rounding accounting, therefore, maintain a stable NAV. In that respect, and in that respect alone, we would revert back to the way the money markets operated from 1971 to 2015 with virtually zero losses for anyone during that entire period of time.

By the way, our legislation would leave in place all of the extensive 2010 and 2014 regulations, and as a condition of having a stable net asset value, our legislation explicitly prohibits the Federal Government from stepping in with any form of bailout and requires that all investors in the fund would be aware of that legal requirement.

Also, let me briefly, Mr. Chairman, mention the BDC issue which we will discuss today. There is an alarming statistic that I would start with, which is that the total number of small businesses in America declined between 2009 and 2014. I am not sure that there is another 5-year period in recent history in which that has happened. But it has happened, and part of the reason is the reason is the difficulty of accessing financing, conventional financing especially, and bank financing. Business development companies have stepped in to fill that void in many cases, including the cases in my State of Pennsylvania. Pittsburgh Glass is a great story where a business development fund operated by Franklin Square Capital provided $180 million, and they did it for one reason: because for Pittsburgh Glass, it was the best financing option available to them.

The House Banking Committee, the Financial Services Committee, has passed legislation that would modernize BDC regulation, and I think it is very constructive legislation. It would allow a modest increase in the leveraging that is available. It would streamline some of their issuing requirements. And I hope this Committee will take up substantively similar legislation, and I am grateful for the fact that we will be able to discuss it today.

Chairman CRAPO. Thank you very much, Senator Toomey.

Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman, for the opportunity. Like many of my colleagues who were formerly State and local public officials, I have always been concerned about ensuring access to capital markets for State and local governments, for housing and transportation authorities, for small businesses, universities, hospitals. And money market funds facilitate that access by investing in short-term municipal debt and holding it to maturity.

In fact, money market funds are the largest investors in short-term municipal bonds and hold nearly $6 billion of municipal bonds in New Jersey. At the end of 2015, money market funds were estimated to hold over $245 billion in municipal debt issuances.

Now, I have heard from elected officials across my State of New Jersey, including the mayor of Elizabeth, the Hudson County business administrator, the Essex County executive, and the New Jersey Association of Counties that represent all 21 counties in the State, that access to the capital markets that they depend on to get the lowest-cost financing for affordable housing, for public infrastructure, and schools appears to be at risk due to unintended consequences of the SEC rule requiring that tax-exempt and prime money market funds must change their method of calculating their net asset value from fixed to floating.

And, Mr. Chairman, I would ask to submit all of those letters for the record.

Chairman CRAPO. Without objection.

Senator MENENDEZ. Thank you.

In addition, I continue to hear from investors and fund managers, including local government officials in my State of New Jersey, who are charged with cash management or municipal finance. They are concerned that instead of making money market funds safer, the floating NAV reporting will significantly reduce the viability of the product as a tool to invest money on a short-term basis.

In response to these concerns by county and local officials, I am pleased to have joined Senator Toomey in cosponsoring the Consumer Financial Choice and Capital Markets Protection Act in an effort to preserve money market funds both as a critical cash management tool for State and local government officials and as a source of liquidity and capital to meet the public infrastructure and investment needs of communities in New Jersey and throughout the country.

I have heard concerns that investors are leaving both prime and tax-exempt money market funds in anticipation of the October 14, 2016, implementation date. And since 2014, several tax-exempt money market funds invested in critical New Jersey State and local debt issuances to support housing, education, infrastructure, and health care facilities have closed or announced plans to close.

The fact of the matter is if investors leave these funds and there is less demand for municipal securities, the borrowing costs for State and local governments will go up. And it is not just them that will feel the effect. State and local governments provide very often a key role in facilitating low-cost financing for nonprofit organizations undertaking vital projects in our State.

So, Mr. Chairman, let me just close by saying I sat on this Committee when we did Dodd-Frank; I was a fierce defender of it; I was someone who authored several provisions of it; and I have fought those who want to slay it. But I do not think the SEC always gets it right, and I do not think they got it right this time, and that is why I am pleased to join in the legislation.

Chairman CRAPO. Thank you, Senator Menendez.

Before we move to the witnesses, I would ask unanimous consent that the following statements and letters be made a part of the record. These have been submitted to the Committee by the institutions and individuals noted: the State Financial Officers Foundation, the Illinois State treasurer, the Mississippi State treasurer, the National Association of Corporate Treasurers, the National Association of Realtors, the Mortgage Bankers Association, the Structured Finance Industry Group, and United Here. Without objection, they will be made a part of the record.

Do any other Senators want to submit a statement for the record?

[No response.]

Chairman CRAPO. All right. With that, we will move to the witnesses. Again, we welcome all of our witnesses here. Although we have a bit of a tight timeframe, I think we will have plenty of time to get through and discuss these issues, and I will tell the witnesses at the beginning now, if we do not have time for all of the Senators—and some of the Senators will not even be able to make it because they have got other intervening commitments—we do have a practice of submitting questions following the hearing and asking for you to respond to those as well.

Our first witness today is the Honorable Ron Crane, who is the Idaho State treasurer. Prior to being elected the State treasurer in 1998, Ron served as a State legislator for 16 years and in that capacity as a member of the House of Representatives. I served with him in the Idaho Legislature, and he is a very good friend of mine. And, Ron, I appreciate you bringing some of Idaho's common sense here to Congress and hope you will leave some with us.

Our second witness is Mr. Michael Arougheti, the cochairman of the board of directors and executive vice president of Ares Capital Corporation, on behalf of the Small Business Investor Alliance.

Our third witness is Mr. Stephen Hall, the legal director and securities specialist of Better Markets, and we appreciate having you here with us.

And our fourth witness is Mr. Drew Fung, the managing director and head of the Debt Investment Group of Clarion Partners, on behalf of the Commercial Real Estate Finance Council.

Gentlemen, we welcome you all. You will see a little timer in front of you. We do have your written testimony, and we actually do read it and study it very carefully. We ask you to try to keep your oral comments to the 5 minutes, as you will see on the timer, and then we will get into some good questions and answers.

With that, Mr. Crane.

STATEMENT OF RON G. CRANE, IDAHO STATE TREASURER

Mr. CRANE. Mr. Chairman, Members of the Subcommittee, thank you for inviting me to participate in this hearing. I serve as the chief financial officer for the State of Idaho and oversee investment portfolios of about $4.4 billion. In addition, my office oversees a number of debt management functions, including the issuance of tax anticipation notes annually

I want to thank you, Mr. Chairman, as well as Senators Toomey and Menendez, for sponsoring Senate bill 1802, the Consumer Financial Choice and Capital Markets Protection Act. This bipartisan legislation will improve access to capital and economic development by preserving the stable-value money market funds for public infrastructure financing and the investment needs of Governments and business.

Following the financial market crisis of 2008, the Securities and Exchange Commission adopted a number of reforms to the regulation of money market funds that helped to improve their liquidity and transparency while reducing interest rate and credit risk in the funds. However, one of those requirements is having significant unintended consequences. Any fund which is available to investors who are not so-called natural persons will be required to transact using a fluctuating or floating NAV instead of a stable $1 per share. This means two things.

First, because the implementation deadline for the floating NAV requirement is fast approaching, a great deal of money is leaving tax-exempt and prime funds right now.

Second, the funds can no longer use that money to provide financing to Governments and other organizations such as hospitals and businesses.

I am going to focus my comments mostly on the impact on tax-exempt funds, but it is there for prime funds, too.

For more than three decades, stable-value, tax-exempt money market funds have been a stable source of short-term financing for cash-flow as well as important funding for public infrastructure and economic development. In Idaho, tax-exempt money market funds provide over $600 million in financing for the tax anticipation notes issued by my office, as well as for projects funded by the Idaho Health Facilities Authority and the Idaho Housing and Finance Association.

Money market funds are the lowest-cost form of borrowing for us. As recently as the end of last year, a health care facility in Idaho was able to pay 7 basis points for financing issued by the Idaho Health Facilities.

Even if you add the cost of credit enhancement and other fees, that financing is significantly less than the 120 basis points they might have to pay for a bank loan or 250 basis points or more that they might have to pay on a long-term bond.

Unfortunately, the floating NAV requirement, which takes effect in October, is forcing investors to leave and causing tax-exempt money market funds to liquidate at a much higher rate than the SEC expected. It is simple. All the non-natural persons have to leave.

A survey by Treasury Strategies shows that at least 40 percent of fund assets are at risk solely because of the floating NAV requirement, and the indirect impacts are likely to make that significantly higher. Just this year, fund sponsors have announced that they have or will be closing 17 tax-exempt money market funds totaling $14.3 billion in assets as a result of the SEC's requirement. This is reducing our choice for funding sources and driving up the cost of financing.

I also want to mention the impact it is having on my ability to invest and manage Idaho's cash. Prime money market funds remain an important cash management tool for approximately 50 percent of the State and local governments' cash that is invested outside of local government investment pools. Since Government entities will no longer be permitted to invest in stable-value prime money market funds, this will limit our investment options to bank deposits and money market funds that invest solely in U.S. Government securities. This means that at the same time as our financing costs are going up, our investment income is going down, and taxpayers have to fill in the gap.

Senate bill 1802 offers a reasonable solution. It enables State and local governments and other non-natural persons to continue to invest in stable-value money market funds across the municipal, prime and Government spectrum. At the same time, it leaves all of the other money market reforms adopted by the SEC intact.

Senate bill 1802 is consistent with the decision of the Government Accounting Standards Board, GASB, to restore the stable NAV for local government investment pools and the recent decision by the European Union regulators to preserve the stable-value money market fund in Europe.

Many of my State treasurer colleagues actively support Senate bill 1802, including the treasurer from Illinois, Treasurer Frerichs; the treasurer of Massachusetts, Treasurer Goldberg; the treasurers of Alabama and Mississippi; and Treasurer Perdue from West Virginia. Their statements, as well as those of many other individuals and organizations representing State and local governments and Main Street issuers and investors, can be found on the Web site of the Coalition for Investor Choice, Protectorinvestorchoice.com.

Again, thank you, Mr. Chairman, for the opportunity to testify on this important issue, and I will be happy to answer any questions that you or Members of the Subcommittee may have.

Chairman CRAPO. Thank you, Mr. Crane.

Mr. Arougheti.

STATEMENT OF MICHAEL J. AROUGHETI, COCHAIRMAN OF THE BOARD OF DIRECTORS, ARES CAPITAL CORPORATION, ON BEHALF OF THE SMALL BUSINESS INVESTOR ALLIANCE

Mr. AROUGHETI. Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, thank you. I am Michael Arougheti, and I am the cochairman of the board of directors of Ares Capital Corporation, an SEC-registered business development company, or BDC, and we are one of the largest nonbank providers of capital to small- and medium-sized businesses in the U.S., or as we like to call them, SMEs, which we believe are the backbone of the U.S. economy.

I appreciate the opportunity to testify today on behalf of the Small Business Investor Alliance, the SBIA, a trade association which represents a majority of the Nation's BDCs. SBIA's BDC member provide vital capital to small- and medium-sized businesses nationwide, resulting in job creation and corollary economic growth.

Ares Capital Corporation is publicly traded on the Nasdaq and is currently the largest publicly traded BDC by both market capitalization and assets. And since our IPO in 2004, we have invested more than $20 billion in over 650 transactions involving hundreds of SMEs in America, and in the process we have created tens of thousands of new jobs and provided capital to growing businesses that were unable to access capital through commercial banks or other traditional financing sources.

Congress created BDCs in 1980 in a period similar to what we saw following the Great Recession. Specifically, Congress created BDCs to enhance capital access to SMEs. Uniquely, though, the BDC model gives ordinary investors the opportunity to finance these small companies themselves, effectively funding Main Street.

BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to access capital from banks. Yet despite what we believe is an outdated regulatory regime, which has been in place since the early 1980s, the number of BDCs has grown, and this growth accelerated following the economic downturn after the 2008 and 2009 recession, where BDCs came in to address the unique needs of these small companies that were starved for capital. Currently, there are over 80 BDCs in the United States, and BDC loan balances have more than tripled since 2008.

While the scope of BDCs' investments may vary, all BDCs share a common investment objective and a common purpose of improving capital access to small- and medium-sized companies. Today the middle-market sector of the economy is responsible for one-third of private sector GDP, and BDCs have grown as commercial banks have withdrawn from lending to this sector.

BDCs now find themselves at the forefront of the effort to address the unmet capital needs of these companies. But the dramatic decline in bank financing for middle-market loans is not a new issue; it is a long-term trend. Middle-market borrowers have historically depended on smaller regional banks for financing, and the number of these banks has been shrinking since the 1990s. In order to continue to provide sufficient access to capital for small- and medium-sized companies, modernization of the BDC regulations is essential. Indeed, modernization will permit BDCs to meaningfully grow and serve these SME clients.

SBIA's BDC members have invested in numerous SMEs throughout the United States. According to AdvantageData, as of March 31, 2016, BDC aggregate loan commitments in the U.S. equaled over $82 billion. To provide an example of the types of investments that we make, Ares Capital Corporation invested in OTG Management, which was a founder-owned operator of full-service restaurants and shops within large airports across the country. Recently, OTG was awarded a contract to build out and operate the food and beverage concession at JetBlue's new Terminal 5 at JFK International Airport and needed to raise capital to complete the construction plan. However, OTG was unable to access financing from traditional sources. It was a small company with a limited operating history, and at the time the only providers of that capital were BDCs. Ares stepped in to fill the voice and provided OTG with much-needed capital as well as management support and expertise to help that business continue to grow.

Ares has also helped fund the growth of many minority owned-and-operated businesses, including ADF Restaurants, which is the second largest Pizza Hut franchisee in the country, with over 250 locations in the Northeast.

Similarly, Main Street Corporation, an SBIA member BDC based in Houston, has funded two of the fastest-growing tech companies in Eugene, Oregon; the largest privately owned jewelry chain store in the Rocky Mountain region; and the leading fixed based operator at the Indianapolis airport.

BDCs are heavily regulated by the SEC and, appropriately, the activities of BDCs are fully transparent to regulators, investors, and portfolio companies. Specifically, publicly traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. These disclosure and other regulatory requirements are extensive and include, among other things, a requirement that BDCs publish a quarterly summary of each investment held by a BDC and the fair value of those investments, which I believe is a significantly greater degree of transparency than we find in other financial services models.

So while we certainly believe in the importance of appropriate regulation, many of the challenges faced by BDCs in increasing the amount of capital that they can lend and deploy are a consequence of where BDCs sit within the regulatory framework. BDCs are more akin to operating companies such as banks and other commercial lenders, yet we are regulated as mutual funds.

So recognizing some of these challenges, the House Financial Services Committee recently passed H.R. 3868, the Small Business Credit Availability Act, with a strong bipartisan vote of 53–4. And I believe that this bill was specifically designed to modernize the BDC sector precisely to enhance our ability to provide capital to growing SMEs as banks continue to retreat from the sector, at the same time ensuring significant and appropriate investor protections specifically requested by the SEC.

Currently, most BDCs maintain an average leverage ratio of 0.5 to 0.75, reflecting a desire and a practical need to maintain adequate cushion in the unprecedented and unlikely event of a sudden and steep drop in asset values. The maintenance of this cushion has the unintended effect of reducing the ability of BDCs sometimes to raise and invest capital, thereby frustrating the original intent of Congress to provide capital to small- and mid-sized businesses.

H.R. 3868, in addressing this specific issue, would permit a modest increase in leverage from 1:1 to 2:1, much less than the typical 10:1 ratio found in traditional banking institutions and on par with the 2:1 ratio under the current SBIC Debenture Program, but without Government guarantee or implied taxpayer subsidy. Importantly, the legislation also includes significant investor safeguards for accessing additional leverage, including a shareholder vote or independent board of directors vote within a 12-month cooling-off period.

The legislation also includes other reforms. These include: allowing for the issuance of multiple classes of institutional preferred stock; permitting BDCs to own registered investment advisers; and allowing for additional investments in financial corporations. With respect to this last point, let me be clear that the modest amendments being proposed do not increase a BDC's ability to invest in securities of private equity funds, hedge funds, CLOs, or other private investment funds.

So, in closing, we believe that the time is right to modernize regulations governing BDCs and to pass legislation, which would allow BDCs to increase capital flows to America's SMEs, spur economic growth, and create jobs. And it is clear that the banks have left this space and are unlikely to return.

SMEs are the engine of our economy, and, unfortunately, many traditional sources of capital are no longer available to them. This bill, in my judgment, represents a strong and necessary effort to modernize the BDC sector so that it can maintain and grow its participation in a growing small and middle market without reducing investor protections.

I apologize for going over. I am happy to answer questions about the bill or any other matters, and on behalf of the SBIA and the BDC industry, I want to thank the Committee for its commitment to increasing capital for growing businesses, and especially its interest in the contribution of BDCs to the overall economy and job growth.

Thank you.

Chairman CRAPO. Thank you, Mr. Arougheti.

Mr. Hall.

STATEMENT OF STEPHEN W. HALL, LEGAL DIRECTOR AND SECURITIES SPECIALIST, BETTER MARKETS, INC.

Mr. HALL. Good morning, Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee. Thank you very much for the opportunity to testify today. I am Stephen Hall, and I serve as the legal director and securities specialist for Better Markets, which is a nonprofit, nonpartisan organization that promotes the public interest in our financial markets.

We believe in capital formation as a means of generating economic growth and prosperity for all Americans. However, deregulation is the wrong way to achieve these goals. The bills at issue here today would actually undermine capital formation in two very important ways:

First, they would expose investors to a greater risk of loss, eroding the confidence that is essential for thriving capital markets;

Second, they would increase the likelihood of another financial crisis, which poses the single greatest threat to capital formation and economic growth in this country.

The 2008 financial crisis proves the point. It destroyed millions of jobs, triggered a tidal wave of home foreclosures, and wiped out the savings of countless American households. The costs have been staggering, and they are still mounting. That includes $20 trillion in lost GDP and untold human suffering.

The lesson is clear: Without effective regulatory safeguards, our financial system is vulnerable to crisis, which can inflict widespread damage on our entire economy, including businesses of all sizes.

Turning to the individual bills, S. 1802 would allow all money market funds to maintain a fixed net asset value. This provision would repeal the SEC's 2014 rule mandating that certain institutional money market funds adopt a floating net asset value. The bill is a step in the wrong direction.

We know from the financial crisis that money market funds are susceptible to runs. When the Reserve Primary Fund broke the buck in September of 2008, a run ensued. It quickly spread to all prime money market funds, and it froze the credit markets. The run subsided only after Treasury took the unprecedented step of guaranteeing, for the first time in history, the entire money market fund industry.

Floating the NAV is necessary to ensure that money market funds remain stable. It reduces an investor's incentive to withdraw from a fund, the first sign of stress. It promotes fairness among investors, and it corrects the basic misconception that money market fund investments cannot lose value. This reform should be allowed to take effect, and it should not be repealed.

H.R. 4620 would weaken the risk retention safeguards applicable to securitizations of commercial real estate loans. This, too, is a step in the wrong direction. The financial crisis again illustrates the point. Before the crisis, the originate to distribute model became pervasive in the residential mortgage market. A similar pattern took hold in commercial real estate where underwriting standards sank to meet demand for loans that could be securitized. When the crisis hit, the toll on these markets was huge. Risk retention requirements are among the most important reforms in this area. They help protect investors, and they inhibit the accumulation of systemic risk.

H.R. 4620 would make two counterproductive changes in the risk retention rule. First, it would create a blanket exemption for the securitization of a single commercial real estate loan or a group of related loans. Second, it would dilute the criteria for qualified commercial real estate loans, which are also fully exempt from the risk retention rule. These changes will weaken important investor safeguards and systemic safeguards in a market prone to systemic risk.

Finally, H.R. 3868 would undermine multiple safeguards that govern the operation of business development companies. Two provisions raise especially strong concerns. One would allow BDCs to double their leverage. This change would expose retail investors to additional risk of loss. Another provision would allow BDCs to invest greater amounts in financial companies, thus diverting capital away from the businesses they were intended and designed to assist. These and other provisions in the bill are simply unwarranted.

In conclusion, I want to thank you again for the opportunity to appear today at this hearing, and I look forward to your questions.

Chairman CRAPO. Thank you, Mr. Hall.

Mr. Fung.

STATEMENT OF DREW FUNG, MANAGING DIRECTOR AND HEAD OF DEBT INVESTMENT GROUP, CLARION PARTNERS, ON BEHALF OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

Mr. FUNG. Thank you, Chairman Crapo, Ranking Member Warner, and Members of the Committee, for the opportunity to testify today. My name is Drew Fung. I am a managing director and the head of the Debt Investment Group at Clarion Partners, and I am here today testifying on behalf of the Commercial Real Estate Finance Council, or CREFC, where I am a member of the executive committee.

CREFC is the collective voice of the $3.1 trillion commercial real estate finance industry. Our 300-plus membership includes balance sheet, agency, and CMBS lenders as well as loan and bond investors and servicing firms. Our industry plays a key role in financing properties of all types in all 50 States, including apartments, nursing homes, grocery stores, retail, just to name a few.

So my testimony today will focus on commercial mortgage-backed securities, or CMBS, as they are commonly known. CMBS has been an essential financing tool in real estate for decades. But in recent years, there have been a plethora of new rules and regulations that have evolved that have dramatically undermined the viability of this important funding source.

So a little bit of background. A conduit, commercial-backed security is a set of bonds that is collateralized by a pool of between 50 and 100 individual commercial mortgages with each loan averaging around $14 million in size. Institutional investors buy these CMBS bonds, and the principal and interest payments due to them are funded by the cash-flows from the mortgaged properties. And the estimated size of the CMBS market today, $500 billion, give or take, so quite sizable.

CMBS plays a key role in commercial real estate lending because it provides much-needed real estate debt capital to markets and properties, particularly in secondary and tertiary markets.

Balance sheet lenders, such as community banks and insurance companies, do not have the capacity on their own to cover the full range of these needs. In fact, in 2015, CMBS provided over 20 percent of all commercial real estate financing, which is over $100 billion of mortgage capital flowing into the markets. CMBS provided 34 percent of all commercial real estate loans to tertiary markets like Boise and Bloomington, and 24 percent of the financing that was put in place in secondary markets like Richmond. No other lender source comes close to serving all these so-called Main Street markets to that extent.

Earlier this year, the CMBS markets were roiled by volatility. Some days it was very near impossible to sell a CMBS bond. Other days the interest rates on bonds that may be bought or sold in the markets was moving up and down by 20 percent. This volatility has translated into CMBS borrowers paying nearly 100 basis points or 1 full percent more for a loan than they would have been required to pay for a loan originated maybe 9 months ago, and this is in an environment where nearly all the economic indicators have remained stable or improved and the delinquency rates in these securities have actually dropped.

But the greater concern, though, is that the availability of CMBS capital to these borrowers could diminish over time if the growing liquidity issues are not addressed. Liquidity is essential to investors who buy these bonds, such as insurance companies, pension funds, and institutions that purchase CMBS bond. Excessive volatility and the resulting loss of liquidity threatens the viability of the CMBS business, thereby reducing borrowers' access to the mortgages provided by the CMBS industry.

So what role does the regulatory environment play here? Well, today bank-affiliated broker-dealers are the primary liquidity providers for the CMBS secondary market. They provide liquidity by maintaining an inventory of bonds that already are in circulation in the marketplace to sell to or buy from investors. So those are market-making activities, and these market-making activities are being burdened by increasing regulation and expanding obligations to hold more capital liquidity and cushion for these loans.

There are eight new or revised accounting capital rules, liquidity rules, including the new Dodd-Frank risk retention rules, which will take effect in December, that are directly impacting CMBS right now, and there are four more on the way.

Each of these new capital requirements increases the cost of issuing and holding CMBS for broker-dealers and, when taken together, poses a serious threat to the CMBS capital flows to borrowers on Main Street. So as new regulatory requirements are finalized and as rules already in place are reevaluated going forward, I think it is very important that the overall impact on the CMBS business and on the economy overall are factored into the evaluation. And it is actually my understanding that policymakers and regulators abroad have already begun to do this.

In closing, a bill that is moving through the House, H.R. 4620, warrants serious consideration. It would improve three elements of the CMBS retention regulations, and contrary to what Mr. Hall said, I believe that by adjusting these three criteria for loans to be deemed qualified, we will actually improve the bond's performance over time while allowing more borrowers access to a qualified loan. On a relative basis, nearly all residential loans made today qualify for the QRM exemption; whereas, conduit CMBS, commercial loans, only 4 percent of the loans qualify.

So, in closing, although CREFC's membership is not always unified in its public policy views given our different roles and interests in the sector, we are unanimous in our support for a stable CMBS marketplace and our growing concern that the increasing lack of market liquidity threatens that stability.

So thank you, Committee, for the opportunity to testify. CREFC looks forward to working with the Committee to address the liquidity concerns I have discussed today, and I would be happy to answer any questions.

Chairman CRAPO. Thank you, Mr. Fung.

I am going to take my question period at the end, so I am going to move first to Senator Warner, and then we will go to Senator Toomey and Senator Corker. Senator Warner.

Senator WARNER. Very generous, Mr. Chairman. Thank you for that. I am going to try to run through these fairly quickly.

On the BDCs, Mr. Arougheti, Mr. Hall, I do believe the business development companies play an important role in the middle markets. I think we have seen a lot of the banks move out of this space. I am sympathetic to expanding your market share and expanding your opportunities, but it seems like the legislation you are proposing is a bit of an overreach. You know, I would like you both to comment on the question. Not only are you looking to increase your leverage ratio from 1:1 to 2:1, which arguments could be made; but at the same time, you are also talking about increasing the percentage of the ability for these BDCs to invest in financial institutions, from 30 percent to 50 percent, and being able to actually buy registered investment advisors.

It seems like one of the two—I would actually be more inclined to be supportive of increasing the leverage ratio, but why would it be in the best interest to both increase your risk profile both in terms of leverage and increase your ability to purchase more financial institutions in and itself, which was never part of the original intent of the BDCs?

Mr. HALL. Thank you, Senator. A couple of points in response to your question.

First of all, in our view, these are indeed—they represent an overhaul. They are not modest adjustments to the regulatory regime. They encompass fundamental aspects of BDC oversight, ranging from leverage, as you noted. They divert money from the companies that Congress intended them to serve. Their ownership of financial institutions is now going to be expanded significantly, and there are even corporate governance provisions and shareholder provisions that are material.

Fundamentally, we come at this from two perspectives. One is: Is there really a need for these kinds of weakenings in the regulatory regime, number one? And, number two, even if there is some sense that adjustments are necessary, what are the consequences of doing do? And here, just as a threshold matter, the BDC community has actually been thriving over the last 10 to 12 years. Measured by assets under management, I believe they have grown by a factor of 10.

At the same time, there are recent reports indicating that their current leverage levels, which are already preferential under the Investment Company Act, are posing pretty serious challenges to them.

It, therefore, strikes us as an inappropriate time to actually weaken oversight of these entities, especially where it runs directly counter to what Congress intended.

Senator WARNER. I guess, Mr. Arougheti, what I would say is I fully agree with Mr. Hall. But, on the other hand, the notion of you are both looking for an increase in leverage and you are looking for further expansion into an area that was not where the original intent of the legislation was headed.

Mr. AROUGHETI. I will try to tie all three of them together because I think there is a prevailing conception that each of those work hand in hand, and they actually do work independent of each other.

I would just quickly say with regard to the leverage, while the BDC industry has been thriving, we are not capitalized well enough to meet the capital needs of the middle-market borrowers that we serve. And I think we could grow more to meet this need.

Number two, as we talk about leverage and the concept of leverage in any financial institution, I think it is important to anchor on other financial services companies as we think about leverage. And as I referenced in our prepared remarks, the SBIC Debenture Program, which has been a very successful Government-sponsored program, currently allows for leverage up to 2:1.

And then, third, with regard to Mr. Hall's commentary on hearsay in the market about challenges of the leverage ratio, I think he is referring to a recent report that was published by the rating agencies that were highlighting not the risks of incremental leverage, but the very challenge that we are discussing today, which is, because of the leverage constraint, management teams who are managing BDCs are having difficulty growing, which I think speaks to the policy.

With regard to the 30-percent basket, I think this is an issue that requires further discussion. This piece of legislation has been talked about collaboratively with the Commission, with the Democrats and the Republicans, for over 4½ years, and the current legislation reflects, I think, some of the concerns that you have raised, which is why there is a prohibition and direction exclusion of investing in funds like private equity funds, hedge funds, CLOs, et cetera.

But, importantly, there are many financial services companies as our economy continues to evolve that have mandates that are consistent with the policy mandate of a BDC. As an example, we have an investment in a small-ticket equipment leasing business that is providing a form of capital directly to the same middle-market borrowers that are borrowing from us——

Senator WARNER. Let me just—because my time is gone. I am sympathetic to potentially leverage. I am not sympathetic to both. I would simply make one quick comment, Mr. Fung, as well. You know, I can understand your concerns on CMBS. There are some of us on the Committee, Senator Corker and I, who believe strongly in risk retention. I would point out that there are major institutions who are being able to close deals operating under the new procedures.

And, finally, Mr. Crane, since I am not going to get to you as well—and I know my colleagues feel strongly the other way, there was a compromise here. The floating NAV, I think, did put across the notion that these are not—there are risks involved in money market funds, and I would simply point out that many of your colleagues in the money market industry were desperately interested in making sure they were not viewed as systemically important and subject to all the FSOC rules. I think if we were to go back from this reform, that might reopen that debate.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Warner.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman.

Mr. Crane, do you have a preference between prime funds and Government funds for your investment purposes?

Mr. CRANE. Mr. Chairman and Senator Toomey, I would tell you that I will draw greater yield from the money market funds than I will from the Government securities.

Senator TOOMEY. And if prime funds became unattractive, unusable for you, it seems to me you have a few options: You could set up shop in-house and invest directly, which would be an extremely cumbersome process for which you may not be well suited. You could just deposit the money in a bank, although banks do not seem to want deposits these days. Or you could go with the Government fund, which you just said—is it true that all of those options offer you less yield or a higher cost or both?

Mr. CRANE. Mr. Chairman and Senator Toomey, you are absolutely correct. We are in the cash management business because we have to keep our funds liquid for expenditure purposes at the ready. So we are looking for vehicles to invest in, but at the same time as being safe, we also want to maximize yield so that taxpayers are not making up the difference. Money market funds offer us that opportunity, and so they are a very good vehicle.

In our case, I have about $4.4 billion under management; probably $230 million of that is in money market funds.

Senator TOOMEY. Thank you, Mr. Crane.

Mr. Hall, in your testimony you state that floating the NAV, first and foremost, is because it reduces the incentive of any investor to expedite withdrawals from a stress money market fund in hopes of redeeming at the dollar price as opposed to something lower, and that "Eliminating this first mover advantage substantially reduces run risk."

We have operated since 1971 with the risk of a first mover advantage. The Reserve Fund is held up as the worst disaster that has ever occurred in the history of money market funds, and that disaster resulted in investors getting 99.1 cents for every dollar that they had invested. And then, subsequent to that, we had a huge wave of new regulations in 2010 and in 2014 which imposed new, more stringent liquidity requirements, diversification requirements, maturity shortening, stress tests, more disclosures, and, importantly, gates and fees which are designed precisely to reduce the risk of first mover advantage in an early run.

My question is: What data do you have to share with me that indicates that that entire wave of new regulations imposed on what had been an extremely safe and secure product prior even to that wave of regulations, what data do you have that shows that the new regulations are inadequate and we need to, in addition, have this floating NAV?

Mr. HALL. Senator, the first point I would like to make is in reference to your sort of review of the history of the performance of the money market funds. It indeed is true that the breaking of the buck by the Reserve Primary Fund was the most significant, dramatic, headline-worthy breaking of the buck in history—and unique in a sense, but it was not unique in another sense, because studies indicate that on hundreds of occasions over the last couple of decades, money market funds have, in fact, teetered on collapse, and but for sponsorship support, they would have actually broken the buck. So there is more vulnerability here than many people seem to acknowledge.

With respect to the underpinning of the floating NAV, I would simply say that the analysis, both economic analysis, regulatory analysis, that supports that measure is amply set forth in two sources. One is, of course, the SEC's rule release. The other is the set of proposed recommendations that the Financial Stability Oversight Council developed. And one of the leading reforms that they recommended to the SEC was floating the NAV for all money market funds, not just a subset of those funds.

So I would suggest that there is ample support for that move——

Senator TOOMEY. Well, there is no question there are people who agree with that, but I would question whether there is data that actually supports the necessity. I would point out the Government Accounting Standards Board has ruled that local government investment pools could continue to use the amortized cost accounting and the penny rounding.

But let me just move on—I am running out of time—to a quick issue. Mr. Arougheti, is it the case that in the legislation, H.R. 3868, any increase in leverage would be fully disclosed to investors?

Mr. AROUGHETI. Yes, it would be fully disclosed. There are two provisions that would require a vote of the independent board of directors to move forward or a cooling-off period after that for shareholders to effectively vote with their feet if they were not comfortable being invested in a BDC that elected to——

Senator TOOMEY. OK. So investors would know that the BDC had a leverage of 2:1 ratio if the legislation permitted that.

My question for Mr. Hall is: Isn't it awfully paternalistic for the Government to say, "We are going to forbid you, Mr. Investor, from having this opportunity to take this leverage in this particular vehicle"? Or is it your view that we should forbid leverage in other cases, too? For instance, it is my understanding that an ordinary investor could use a margin account and buy stock in a bank and achieve many, many multiples of leverage. Would you advocate eliminating margin for ordinary investors also? Or why are we singling out this particular vehicle as one that cannot exercise really what is a modest amount of additional leverage?

Mr. HALL. I think the answer, Senator, lies in two sources. One is the 1980 statute that actually acknowledged or created the framework for these companies. They were created for a very specific purpose, and it was acknowledged at that time that their very business model that is one that caters to companies that are less creditworthy than others is inherently risky in certain respects.

The idea was to help the middle-tier and small-tier companies get capital that they could not otherwise get.

The other thing is that the amendments that are being sought here, they are not as simple as just doubling leverage. It is actually more than that when you factor in the indirect increase in leverage that comes from the ability under this bill, if it is enacted, to expand investment into financial companies that are themselves leveraged.

So to get to your question, it is not about being paternalistic at all. It is about respecting the judgments that have long been made about how to strike the right balance between helping these companies on the one hand and protecting investors on the other. And the history of securities regulation is replete with examples of limitations on the nature of the investor who is permitted to actually put their funds at risk through the accredited investor concept. There are loads of protections that can be characterized in some sense as paternalistic, but they are not. They are protecting investors, and they are in many cases safeguarding our system against systemic risk.

Senator TOOMEY. I see I have run out of time and gone over, so thank you for the indulgence, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Treasurer Crane, you pointed out in your testimony that, according to statistics released on April 20th by the SEC, gross yields on tax-exempt money market funds increases from 8 basis points in February to 35 basis points in March. With this significant jump in tax-exempt yields, how is this going to impact the ability of State and local governments to finance infrastructure and economic development projects?

Mr. CRANE. Mr. Chairman and Senator Menendez, my guess is it is going to have a dramatic impact, and it is already having an impact on the markets. For example, in the State of Idaho, we have the Idaho Housing and Finance Association that provides low-income housing. We have the Idaho Health Facilities Authority that builds hospitals. Those bonds are sold to the money market funds. And if there are less money market funds, then the cost is going to go up, and the person that is going to pick that up is the taxpayer.

Senator MENENDEZ. Let me ask you this: In your testimony you highlighted that the Government Accounting Standards Board acted to permit you to offer your local government investment pools with a stable unit price. Can you tell us a little bit about the Government Accounting Standards Board and its decision?

Mr. CRANE. Well, Mr. Chairman and Senator Menendez, they recognized that the floating NAV was not good for accounting purposes as far as the LGIPs were concerned, and so they repealed that rule and allow us to amortize our costs and our increases from an accounting standpoint, and rightfully so. They recognized it was a mistake and reversed themselves. I think they did the right thing.

Senator MENENDEZ. Let me ask you this: If State and local government are faced with impeded access to the capital markets through the closure of tax-exempt money market funds, what other options exist for low-cost financing of critical community and infrastructure projects?

Mr. CRANE. Mr. Chairman and Senator Menendez, I am not probably the best one to answer, but I can tell you that if you are going to go out and go into the bonding market and sell bonds, you are going to pay probably 120 basis points more, maybe 250 basis points more. You have got the banks that you can use. That is going to be a significant increase in cost. Or you can go out and bond for it, and it is going to be much more expensive than it currently is.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Corker.

Senator CORKER. Thank you. Thanks for having this hearing, and I thank all of you for testifying.

Mr. Arougheti, BDCs are something that in the past I have not spent a lot of time on. When you invest in these companies or provide capital, is it in the form of equity, mezzanine loans, direct loans? Is it all three of those?

Mr. AROUGHETI. It is all three of those. The BDCs have the flexibility—and I think it is an important point to discuss—to make common equity investments, mezzanine investments, or senior loans, all with the goal of providing growth capital. As the capital markets have evolved and banks have left, it is actually the exact opposite of what Mr. Hall said. We are actually seeing larger companies come to the BDC market to access financing and more senior secured types of investments.

The knock-on effect of that is when we are talking about access——

Senator CORKER. I have got 5 minutes. So the investors that invest—you know, it is a public company—is there any lockout or can they trade daily, they can get in and out of it?

Mr. AROUGHETI. Daily trading.

Senator CORKER. Yeah. And, you know, you all have operated for 36 years with a 1:1 debt-to-equity ratio. It is modest, but it is doubling. What is actually driving—well, first of all, what kind of return on equity did your company have last year?

Mr. AROUGHETI. About 10 percent.

Senator CORKER. So with the additional debt, there will be some costs there. You could drive that up to 18 percent or so?

Mr. AROUGHETI. I think it would be the opposite. So what I expect will happen with the increase——

Senator CORKER. Well, now, wait a minute. How could that—that is not possible.

Mr. AROUGHETI. What would wind up happening is we would be investing in lower-yielding senior secured debt. The way the BDCs are structures now is if they invest in mezzanine or equity, the capital markets, be it bank or bond markets, will not actually leverage those assets. So the choice as a management team is invest in, quote-unquote, riskier illiquid assets with no leverage to drive a 10-percent ROE or invest in higher-quality, lower-yielding senior securities with leverage to generate the same——

Senator CORKER. So the additional leverage would allow you to be more involved in prime-type loans. Is that——

Mr. AROUGHETI. Yes, it would broaden the product set, and it would give us another tool to bring into the middle market, absolutely.

Senator CORKER. And the interest in investing in financial institutions, what is driving that? That does seem, just for what it is worth, somewhat odd as it relates to this legislation?

Mr. AROUGHETI. Yeah, I think it is a recognition that the face of the economy has changed in the 36 years since the legislation was passed, that financial services companies in and of themselves are a larger part of the GDP; they are job creators themselves. I think this is a relevant conversation. As I said, the legislation has tried to identify those types of financial instruments that cause concern.

Senator CORKER. So if you were going to—if your ceiling was increased from 30 to 50 or whatever, as it relates to financial institutions, would you envision then—that would be more of an equity investment, would it not, not a lending type situation?

Mr. AROUGHETI. Each BDC is different, but when people are investing in financial services in that 30-percent basket, it does tend to be an equity investment. And back to my earlier comment, those in and of themselves are not leverageable. So I think the concern of leveraging leverage by investing in financial services companies is probably——

Senator CORKER. So an investor today in your company would have a year, there would be a cooling-off period. They can get out of the stock after this testimony if they decide, and then they would be investing in a company that they understand has got additional leverage and is probably going to be more focused toward using that money for lending, not for equity itself. Would that be a fair assumption?

Mr. AROUGHETI. Yes, that is my view.

Senator CORKER. Let me ask you, Mr. Fung, on the conduit lending, I have participated in that in the past and understand it somewhat. What is the 4-percent box you are talking about? What are the limitations on a qualified mortgage that make that box so small?

Mr. FUNG. Well, the QCRE, qualified commercial real estate, loan box is smaller now because there are limitations on interest-only, there are limitations on loan-to-value. And what they are effecting is actually they are applying equally across all the different type of loans, including the absolute most safe, lower leverage, high debt service coverage loans.

So this, frankly, is about a very modest change——

Senator CORKER. What I did not hear in your testimony was what the limiting factors are that are keeping the box so small. I am out of time, but can you quickly lay out what is causing only 4 percent of the conduit loans to——

Mr. FUNG. To not qualify.

Senator CORKER. That is right.

Mr. FUNG. Yeah, basically those loans are not qualified because they have either too high loan-to-value or a debt service coverage ratio that might not meet this broad-brushed test. But it is about an overall credit picture of each loan, and so, you know, the one or two factors that are being considered are probably not absolutely appropriate.

Senator CORKER. Well, I would like to talk to you in more detail. You know, having had some experience, I will say conduit lending typically has had much—they have been far more aggressive, if you will, than life insurers and others. I mean, I think that is a fact. And so I would like to understand——

Mr. FUNG. That is true.

Senator CORKER. You agree with that, right?

Mr. FUNG. I do.

Senator CORKER. So if you would, I would love for you to come into our office and explain. I am just having difficulties understanding what those limiting factors are, and I really would like to understand.

Thank you all for your testimony and for being here today, and thank you, Mr. Chairman, for having this hearing.

Chairman CRAPO. Thank you, Senator Corker.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you for having this hearing today. Thank you all for being here.

In 1980, Congress created these business development companies, or BDCs, as special investment vehicles with the goal of giving small businesses more access to capital. And Congress required BDCs to invest at least 70 percent of their money in small businesses. And as an incentive to attract investors to BDCs, Congress put a big carrot on the table and exempted BDCs from corporate income taxes.

Now, I know a lot of BDCs focus on small business investments and fill a hole in the market. I know a lot of companies in Massachusetts and across the country get investment money from BDCs. But I am concerned that some of the largest BDCs have turned this into a raw deal for investors, and the bill before us today would take a bad deal and make it worse.

Mr. Arougheti, you run the biggest BDC in the country, Ares Capital, and I took a look at some of the disclosures your company submitted to the SEC, and, frankly, I have got to say they are pretty shocking. Over the last decade, your management and incentive fees have risen by over 35 percent annually. They have nearly doubled every 2 years. Meanwhile, total returns to shareholders in that same time period have risen by only about 5 percent. And because of lousy numbers like these, institutional investors are bailing out of BDCs, leaving behind a lot of mom-and-pop investors who may not realize that they are getting fleeced.

Mr. Arougheti, you have been pushing for legislation that would allow your company to borrow more money and increase your leverage. In fact, your company alone has spent $1.5 million lobbying on this issue in the last few years, and you say that is because you want to be able to invest in more small businesses. But it seems to me that is something of a misdirection.

If you really want to have more money to invest, why don't you lower your high fees and offer better returns to your investors? Then you get more money, and you can go invest it in small businesses.

Mr. AROUGHETI. Thank you for the question, Senator. I think when we talk about ROEs on entities that are required by law to distribute 90 to 100 percent of their income, it is not a corollary to look at other operating companies to talk about a 5-percent increase in shareholder value because effectively——

Senator WARREN. So you are saying that, in effect, you have doubled the return every couple of years to your investors?

Mr. AROUGHETI. Right. The way I would encourage people to look at the math is you have to actually look at the reinvestment of those dividends because BDCs do not have——

Senator WARREN. So I have watched your fees nearly double every 2 years. What I am trying to get at is if you are saying the return is also doubling nearly every 2 years, then I do not get why the market has not just solved this? Why aren't people flocking to you wanting to invest more money and you have got plenty of money——

Mr. AROUGHETI. Well, I think that they are, so——

Senator WARREN. ——to put into small businesses?

Mr. AROUGHETI. I think that they are. We IPO'd in 2004 with an equity market capital——

Senator WARREN. Well, if you have got plenty of money, then why are you coming to Congress asking for a shift in the allocations so that you can attract even more money?

Mr. AROUGHETI. Sure, so it is somewhat circular. So when we——

Senator WARREN. Yeah, it is.

Mr. AROUGHETI. When we IPO'd in 2004, we had an equity market capitalization of $165 million and 11 people. Today we have an equity market capitalization of $4 billion and hundreds of people who are in local markets making middle-market loans. So——

Senator WARREN. And yet the institutional investors seem to be leaving you and leaving only the mom-and-pops behind.

Mr. AROUGHETI. I do not think that that is true. Sixty percent of the investors in Ares Capital Corporate are large mutual fund complexes. There are actually some constrains that we——

Senator WARREN. You are saying that in the industry institutional investors are moving in to BDCs?

Mr. AROUGHETI. Institutional investors are about 50 to 60 percent——

Senator WARREN. Are you saying they are moving in, what the slope looks like?

Mr. AROUGHETI. Well, I think they are stable. I think that there are——

Senator WARREN. That is not the data I am seeing, but let me get to another issue here. I also want to focus on an aspect of the BDC bill that you are pushing. BDCs right now can invest up to 30 percent of their money in things other than small businesses, including hedge funds or other financial firms. Ares has taken full advantage of this to funnel money into financial firms. At the end of last year, it had about 26 percent of its money in financial services companies.

Now, this bill would let BDCs dedicate another 20 percent of their investments to financial companies rather than to small businesses, which means that BDCs could invest half of their money in financial firms and still get all of the no-taxes break that was offered to get them to invest directly into small businesses.

If the goal of this bill is to promote investment in small businesses that make things and provide services to their communities, then why does it allow BDCs to divert even more money, up to 50 percent of their portfolio, away from small businesses and into other financial firms?

Mr. AROUGHETI. Sure. So I will use Ares Capital Corporation as an example because you referenced 26 percent of our balance sheet in financial services firms. Back to my comments earlier about transparency, if you were to look at our filed financial statements, you would actually see that those are not financial services firms, but it is an investment in two joint ventures that we have with a large insurance company, a large specialty finance company that make middle market loans.

Senator WARREN. Look, let us be clear. We are talking—sorry. We are talking about an amendment here that says that you can go up to 50 percent of your investments, not in small businesses, and still get all the tax breaks that Congress created so that you would invest in small businesses.

I am out of time here, but I have got to say I am very concerned about the business model that big BDCs like Ares are using, essentially imposing private equity-like fees on mom-and-pop investors without any of the same kind of potential upside. And I am very concerned about aspects of this bill which would allow firms like Ares to borrow a whole lot more money, divert billions of dollars away from small businesses to hedge funds and other financial institutions, and collect even more management fees, all while preserving special tax breaks and not doing anything to help either small businesses or BDC investors.

As this bill is currently written, it is a giveaway to BDC executives, and it is masquerading as a small business bill. If Congress decides to act on BDCs, it should focus on the best interests of investors and on small businesses, not on BDC management.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Warren.

The vote has been called, or the beginning of the series of votes has been called. Senator Donnelly, you and I are the only two who have not gone. I will give you your shot now, and then I will try to wrap up real fast, and maybe we can——

Senator DONNELLY. Thanks. I will try to abbreviate it a little bit, too, then, Mr. Chairman. Thank you.

Mr. Crane, what impact will a floating NAV rule have on the ability of municipal governments to obtain affordable financing?

Mr. CRANE. Mr. Chairman and Senator Donnelly, I think it will have a negative impact. I think it already is having a negative impact. For example, I borrow about $500 million in tax anticipate notes annually as a bridge loan for the State of Idaho from November 15th to April 15th when the bulk of our revenues come in. And the cost that I paid last year was 29 basis points. This year, we just did a market study. We will go into the market in about 2 weeks. That will be between 58 and 60 basis points, so it is doubling our cost to our taxpayers. That is happening not only in the situation where Idaho borrows short-term notes, but also in other borrowing that occurs as well.

Senator DONNELLY. The reforms that were put in place in response to the financial crisis of 2008, do you think the floating NAV reform improves financial stability and reduces systemic risk or not?

Mr. CRANE. Mr. Chairman and Senator Donnelly, I think that probably this was a mistake that the SEC made. This particular legislation does not really repeal anything as far as Dodd-Frank is concerned. But I think there were unintended consequences by the rule that was proposed, and I think it is a reasonable fix and will assist.

Senator DONNELLY. Mr. Arougheti, the bill changes leverage guidelines for BDCs, and increased leverage can be extraordinarily dangerous. Why would those changes not be risky?

Mr. AROUGHETI. I articulated it again. I will try to say it in——

Senator DONNELLY. I appreciate it. I apologize that I have other obligations around here, too.

Mr. AROUGHETI. No, I think you were here when I said it, so I apologize if I am repeating myself. But the way that the BDCs are structured, we actually access our leverage from banks themselves and from the unsecured debt markets. And if you look at the existing credit facilities that govern BDC leverage, they articulate in very great detail what assets are leverageable or not. And this is all publicly files, so if you were to look at Ares Capital Corporation's financial statements, you would see that we could borrow 2½ to 1 on a senior secured loan but 0 on an equity investment.

So the Governors are already in place within the market to allow BDCs to borrow based on asset composition. So as I said earlier, if we were to leverage in excess of the current regulatory limit, it would by definition require that we were investing in senior secured loans and lower-risk assets; otherwise, you could not access the leverage.

Senator DONNELLY. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Donnelly. Actually, you asked a couple of my questions, so you will help me be even more brief.

I have just a couple of things to wrap up, and then we might actually make it to the vote.

I again want to thank you, Mr. Crane, for coming and bringing Idaho's common sense here to Congress, and I appreciate you having done that. You just went through the numbers I wanted you to with Senator Donnelly, so I am going to move over to Mr. Fung.

Again, referring to the floating NAV issue, my understanding is that there are about $100 billion of loans in commercial mortgage-backed securities that are set to mature in 2017. Is that correct?

Mr. FUNG. Ye, that is the current estimate.

Chairman CRAPO. What would be the expected increase in borrowing costs on those loans if we do not resolve this floating NAV issue?

Mr. FUNG. It is probably in the neighborhood of 30 to 50 basis points, is our best guess. It could be as high as a 1-percent increase. It is still a bit of a question until the first securitization hits the market, subject to the current risk retention rules. Nobody knows exactly what the increased cost will be to pass along to the borrowers. But what is clear today is that there are a number of issuers who are already leaving the market, so less capital flowing through to the secondary and tertiary markets I discussed in my testimony, as well as increased volatility causing decrease interest in, on the investor side, people buying the CMBS bonds, and that, you know, increased volatility makes it difficult to price the rate that we pass along to the borrower. And so you will see somewhere along a 30- to 50-basis-point increase, is our guess.

Chairman CRAPO. All right. Thank you very much. I do have a whole bunch of questions here for the rest of the panel, but we also only have 5 minutes to get over to the Capitol. So at this point, I want to thank all of the witnesses for the time and effort that you have put into this to bring this information to us. You may get a few questions from some of the Senators. We would appreciate you responding to those timely. These are important issues, and I appreciate the input that you have provided to us today.

The hearing is adjourned.

[Whereupon, at 11:27 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today's hearing will provide insights into how business development companies, commercial real estate finance, and money market mutual funds provide access to capital and economic development for communities and businesses.

There is a growing chorus that pending and existing Federal rules and statutory limitations are restricting access to capital and restraining economic growth.

Because it is important for Congress to understand the factors that are impacting local communities and businesses, I welcome a discussion about specific proposals that would improve the current regulatory framework while maintaining proper safeguards.

The House Financial Services Committee has already examined proposals to modernize the regulations for Business Development Companies and adjust the risk retention rules for commercial real estate loans.

Senators Toomey and Menendez have introduced legislation to restore the stable share price for institutional, nongovernment money market funds.

I look forward to hearing from our witnesses on these legislative proposals and learning what specific factors, including Federal regulations, are negatively impacting lending and borrowing in local communities.

For example: How a pending regulatory effective date will impact commercial real estate financing since almost $100 billion of loans in commercial mortgage backed securities are set to mature in 2017—up from $52 billion this year.

What will be the impact on State Treasurers to invest and use money market mutual funds when several types of these funds will be required to switch from a stable to a floating net asset value in October?

What statutory changes can be made to allow business development companies to increase investments in small- and middle-market companies and enable investors to invest alongside with them and still provide adequate investor protections?

Thank you.

PREPARED STATEMENT OF RON G. CRANE

IDAHO STATE TREASURER

MAY 19, 2016

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, I appreciate the opportunity to provide testimony on legislative proposals to improve access to capital and economic development for communities and businesses.

As the statewide-elected Treasurer of Idaho since 1998, I am responsible for the State's debt management, including the issuance of both short term debt, such as Tax Anticipation Notes, and bonds. My office oversees a number of debt management programs that support public infrastructure investment, including the Idaho Bond Bank Authority, the Idaho School Bond Guaranty Program, and Tax Anticipation Notes. Also established in statute are the Idaho Health Facilities Authority, which provides financing to nonprofit health care providers; the Idaho Housing and Finance Association, which issues revenue bonds to finance affordable housing; and the Idaho State Building Authority, which functions as the capital financing arm of the State.

Also, on the cash management side, I am responsible for investing all general account and pooled agency cash, as well as managing Idaho's $3.2 billion local government investment pool (LGIP).

I direct receipt of all State monies, and the accounting and disbursement of public funds.

In particular, I want to focus my comments today on S. 1802, the Consumer Financial Choice and Capital Markets Protection Act.

This bipartisan legislation is important to protecting the financing and investment options of Governments, businesses and communities in Idaho and throughout the country. I want to express my gratitude to Senators Toomey and Menendez, as well as to you, Mr. Chairman, for your sponsorship of that legislation.

Background

The Securities and Exchange Commission (SEC) has taken important actions since the financial crisis of 2008 to strengthen the resiliency of money market funds, reduce systemic risk, and protect investors. In 2010, the SEC imposed new liquidity and transparency requirements on money market mutual funds that have proven successful through several market stresses, including the European debt crisis of 2011, the U.S. debt ceiling impasse and concerns about the downgrading of U.S. debt that same year, and the debt-ceiling standoff in 2013.

Then in July 2014, the SEC adopted additional obligations on money market funds, including enhanced disclosures, stress testing, and increased, portfolio diversification requirements, among other things. Like the 2010 reforms, these are welcome changes that have strengthened the ability of money market funds to safely meet the cash management and short-term investment needs of businesses, State and local governments, and other institutions.

However, as part of the July 2014 amendments to Rule 2a-7, the SEC also adopted a requirement, effective on October 14 of this year, which in effect eliminates the utility of any money market fund to investors who are not "natural persons" (in the terminology of the Rule) unless the fund invests exclusively in U.S. Government securities.

Under this new requirement, any tax-exempt or prime money market fund accepting any investor other than a "natural person" will no longer be able to offer and redeem shares based on amortized cost valuation of its portfolio to produce a stable, $1 net asset value (NAV). Instead, such funds will have to apply a fluctuating or "floating" NAV using market-based estimated values. Simply, again, the floating NAV goes beyond regulation of the money market fund to just kill it as a cash management tool. I do not believe cash investors, such as myself, want, or will use, a floating NAV fund for cash investments.

Thus, by October 14, all investors other than "natural persons" are forced to leave any stable value, dollar per share, prime or tax-exempt money market fund. Since these investors are managing cash, they will be looking to move to a different, stable-value cash management vehicle. As a practical matter, this means most will either put their cash in a money market fund investing exclusively in U.S. Government securities or deposit their cash in the bank.

In either case, that money will no longer be available in the portfolio of a prime or true-exempt fund to loan to businesses or invest in tax-exempt notes and bonds of Idaho, other State and local governments, and other nongovemment issuers such as hospitals and universities.

Treasury Strategies Survey

Attached as an Appendix to this Statement is a survey and analysis of the extent to which the assets of tax-exempt money market funds are from "non-natural persons" performed by Treasury Strategies, an economic consulting firm, for The Coalition for Investor Choice.

Treasury Strategies' work to document the impact of the SEC's new requirement forcing out "non-natural" person investors provides accurate data to underlie your support of S. 1802. To my knowledge, no one else has undertaken to discern this impact, including the SEC.[1]

How S. 1802 Supports Economic Development

Treasury Strategies has concluded that this one SEC requirement, by itself, will reduce the assets in tax-exempt money market funds by at least 40 percent.

Further, as Treasury Strategies' Report shows, in anticipation of this loss of assets, many funds lose viability and are simply liquidating, in total, now. Those who are not liquidating, but remain uncertain as to the extent of the loss of assets they will experience by October, are actively shortening their portfolio maturities.

At the end of 2015, tax-exempt money market funds held about $263 billion in assets.[2] That is about 6.5 percent of the total tax-exempt debt market. But it's about two-thirds of the short-term municipal debt market, and that has varied between two-thirds and 80 percent over the past 5 years.

This is all money that is invested in funding State and local government. The Treasury Strategies' Report shows you how those investments span the country, both in absolute and per capita terms. While States such as New York, Massachusetts, Illinois, Pennsylvania, New Jersey, Indiana, and Ohio[3] stand out as among

[1] In its Release adopting the 2014 amendments to Rule 2a-7, the SEC asserted that "institutional" investors likely held less than 15 percent of tax-exempt money market fund assets. Money Market fund Reform, Amendments to Form PF, *www.sec.gov/rules/final/2014/33-9616.pdf* at p.244; 79 *FR* 47736 (Aug. 14, 2014). However, the SEC was relying on data differentiating "institutional" and "retail" funds by criteria such as minimum account size; not the distinction in its rule of "natural" vs. "non-natural" persons. In addition, the SEC asserted that such data overstated "institutional" assets because omnibus accounts likely consisted of retail investors. Thus, the SEC assumed, without comparable data or performing its own study, that its action would not significantly impact the assets of tax-exempt money market funds. The present impact is an unintended consequence.

[2] *https://www.sec.gov/divisions/investment/mmf-statistics/mmf-statistics-2016-3.pdf*

[3] Many supporters of S. 1802, in addition to myself, have acknowledged their support or made their letters available to the Coalition for Investor Choice. See *www.protectinvestorchoice.com*. For example: Letter of Massachusetts Treasurer Deborah B. Goldberg to Senator Warren (Feb-

the largest ten issuers in absolute dollar terms, the impact on Idaho is very significant on a per capita basis, along with every other State, including Virginia, Rhode Island, Montana, Tennessee, Louisiana, South Carolina, Nebraska, and Kansas.

We in Idaho, including both State and local government directly, as well as other Idaho issuers, benefit from over $600 million of money market fund investments. If tax-exempt money market funds lose, at a minimum, half of their assets because "non-natural persons" are no longer permitted to invest in them, that implies that Idaho could lose at least $300 million of its present financing from this source at the present rates.

What, then, will my choices be for an alternative funding source? There will be two options. First, I will likely have to pay higher interest rates in order to place my debt. This is the most basic principle of supply and demand in the auction process of the market. When the assets available for investment go down, but the demand does not, the cost will go up.

This impact is occurring right now. For example, each year I take approximately $500 million in Tax Anticipation Notes to market—and these notes have always been purchased by an array of different tax-exempt money market funds. There are substantially fewer bidders this year, and I've already been told my cost is going up.

All issuers of municipal debt and nongovernment conduit borrowers are already beginning to feel the impact of the shrinkage in tax-exempt money market fund assets as a result of the floating NAV requirement. According to statistics released on April 20 by the SEC, gross yields on tax-exempt money market funds increased from eight basis points in February to 35 basis points in March. [4] This is not good news for State and local governments, school districts, port authorities, hospitals, universities, and others that have to pay more for working capital or to finance infrastructure and economic development projects that support local businesses, including contractors and engineering firms.

My second option is to borrow the money in a different form, or from a different source, than a money market fund. For example, I can go seek a loan from a bank.

Short-term borrowing in the capital markets has always been the lowest cost form of funding. This is the fundamental notion of the yield curve: short-term borrowing costs less than long-term borrowing. I would add that tax-exempt borrowing is normally less expensive than taxable loans. Thus, borrowing in the capital markets, such as from money market funds, costs less than borrowing from a bank.

For a State or local government with a good credit rating, its financing authorities could expect to pay approximately 110 basis points more to borrow from a bank than to issue debt held by a money market fund. This would be at prevailing rates of LIBOR plus 40 to 50 basis points. For example, an entity that regularly borrows $10 million short-term through the issuance of Tax Anticipation Notes (TANs) would see its borrowing costs rise more than $100,000 per year if the debt could not be placed with money market funds and bank credit was needed as an alternative. Other, less credit worthy borrowers who need credit enhancement could see their cost of debt increase 200 to 300 basis points.

These disruptions to financing by money market funds are occurring on top of other regulatory actions that are impacting liquidity and cost for municipal borrowing; including the Basel III bank capital rules and the SEC's proposed liquidity standards for bond mutual funds.

I would note that total tax-exempt assets held by money market funds were over $500 billion as recently as 2009 and, through October of last year, most of that decline was the result of the Fed's zero interest rate policy.

As an aside, to return to my point that cash investors do not want a floating NAV money market fund:

At a time when money market funds are offering annual yields of only a handful of basis points to invest on a dollar in–dollar out basis, the stable value is a big reason why money market funds continue to hold, and attract, nearly $2.6 trillion in assets. Again, as the Treasury Strategies' Report shows, regulators cannot force investors to invest in floating NAV funds and the Fund Sponsors themselves are not anticipating that investors will stay. Fund Sponsors are simply liquidating their

ruary 26, 2016); Letter of Carole Brown, Chief Financial Officer, City of Chicago to Senator Kirk (April 13, 2016); Letter of David J. Gray, Treasurer, Penn State University to Senator Toomey (December 14, 2015); Letter of Ann M. Cannon, President, New Jersey Association of Counties, to Senators Menendez and Booker; Letter of David Bottoroff of Association of Indiana Counties and Nancy Marsh, Indiana County Treasurers' Association, to Senator Donnelly (June 5, 2015); and Letter of Matthew A. Szollossi, Executive Director, Affiliated Construction Trades of Ohio, to Senator Brown (October 24, 2015).

[4] *https://www.sec.gov/divisions/investmentlmmf-statistics/mmf-statistics-2016-3.pdf*

tax-exempt funds, and converting the prime funds, and expecting those assets to move to Government funds or elsewhere.

Now, back to the $500 billion peak. It would be fair to assume that, absent the floating NAV requirement, once short-term rates begin to rise again, investors would flood back into tax exempt money market funds and assets could exceed $500 billion again. That's a lot of potential liquidity for building and maintaining hospitals, schools, roads, public transportation systems, airports, and other infrastructure projects. This implies that ample, low-cost funding would remain available to Idaho issuers, and your States' issuers, from tax-exempt money market funds.

There's an indirect negative consequence of the floating NAV that will also be averted by enactment of S. 1802. As funding options become more limited, the credit ratings of States and municipalities will come under pressure and potentially lead to additional costs. Rating agencies use access to capital as an important variable. When tax-exempt money market funds close and municipalities have fewer buyers for their debt, it becomes a risk factor that could lead to ratings downgrades .and even higher borrowing costs.

Although I am responsible for the investment and financing activities of the Idaho State Government, I think it is also important to mention the fact that money market funds do more than just support public infrastructure investment in our State. Prime money market funds currently invest in billions of dollars of short-term commercial paper issued by Idaho businesses to finance their payrolls and inventories, as well as the purchase of new equipment. JPMorgan Chase estimates that, as a result of the SEC's 2014 actions, at least $400 billion in prime money market fund assets will be converted to funds the invest solely in U.S. Government securities.[5] The net result will be to reduce the Federal Government's borrowing costs at the expense of main street businesses that are the backbone of our local economies.

Local Government Investment Pools

As Idaho State Treasurer, I am both a manager of, and investor in, money market funds, as well as being a borrower from them.

First, here is how the SEC floating NAV requirement impacted me as the manager, in Idaho, of an investment pool that is equivalent to a prime money market fund.

I am responsible for the management of our LGIP, which we offer to Idaho municipalities and other local government subdivisions for their cash management. It has a daily balance in excess of $3.2 billion. LGIPs use amortized cost valuation to operate similarly to money market funds and offer their participants a stable, $1 unit price.

Although LGIPs are exempt from registration under the Investment Company Act, and therefore not directly subject to Rule 2a-7, they are still subject to Government Accounting Standards Board (GASB) accounting principles. GASB sets accounting and financial reporting standards for external investment pools and pool participants. Until recently, GASB principles required LGIPs to follow 2a-7 like procedures. Thus, when the SEC said that "non-natural persons", such as Idaho local governments, can no longer benefit from amortized cost, our Idaho LGIP was faced with the prospect of not being able to comply with the GASB accounting principle.

This past December, GASB acted to restore amortized cost to LGIPs by issuing accounting statement No. 79.[6] It requires LGIPs to meet many of the requirements of Rule 2a-7, such as portfolio duration and maturity, quality of portfolio assets, diversification of investments, and portfolio liquidity, but "de-links" from Rule 2a-7 to permit LGIPs to continue to use amortized cost valuation and penny rounding, and thereby transact with participants at a stable NAV per unit or share.

Your enactment of S. 1802 restores the stable, $1 per share of the money market fund by enabling any money market fund to elect to continue to use the amortized cost method of valuing its portfolio.

How S. 1802 Supports Liquidity Management

Although, thanks to GASB, our LGIP is not subject to the pending floating NAV requirement of the SEC's Rule 2a-7, we are still impacted by that requirement. Like in other States, apart from LGIPs, we also invest public cash in financial instruments that meet the investment policies of our State code, as well our investment objective priorities of safety, liquidity and yield. Eligible instruments include Treas-

[5] See "The $400 Billion Money-Fund Exodus With Banks in Its Crosshairs", *Bloomberg Business*, Feb. 23, 2016.

[6] *http://www.gasb.org/cs/ContentServer?c==Pronouncement__C&pagename=GASBo/o2FPronouncement__C%2FGASB SummaryPage&cid=1176167863852*

uries, U.S. Government agency securities, and stable value Government and prime money market funds.

Safety of principal is the foremost objective of our investment program. That is why, in addition to Idaho's LGIP, State agencies and local municipalities also use money market funds where appropriate for specialized cash management applications. For example, at any point in time, Idaho agencies and public entities will have between $300 and $500 million invested in prime money market funds.

If stable value prime money market funds are no longer a permitted investment option, Treasurers will have limited choices for using pooled investment vehicles to invest in financial instruments that meet the needs of their investment programs. Further, with over $400 billion in prime money market fund assets converting to Government funds, rates on U.S. Treasuries are being driven even lower.

Even in the absence of the SEC's floating NAV requirement, liquidity management is an enormous challenge for State and local government entities. This makes enactment of S. 1802 doubly important. It will allow our liquidity management programs to continue to hold money markets funds in their portfolios that invest in assets other than U.S. Government securities. In addition to capital preservation, it will allow us to earn market rates of return throughout budgetary and economic cycles, which benefits our citizens.

Conclusion

S. 1802 will do much to preserve Idaho's access to capital and economic development for our communities and businesses. It will preserve stable value money market funds as a safe, liquid, market-rate investment for our State's cash management needs, and as a source of capital for public infrastructure investment and businesses growth. At the same time, this legislation protects the positive changes adopted by the SEC in 2010 and 2014 that have mitigated risk in, and strengthened the resilience of, money market funds without disturbing the authority of the SEC to regulate money market funds in its discretion. In S. 1802, Congress properly exercises its discretion to draw the policy line between regulating money market funds and killing them by imposing a floating NAV requirement.

I appreciate your leadership on this issue, Mr. Chairman, and encourage the full Senate to support S. 1802 and protect the liquidity and investment options of State and local governments and all other investors.

Treasury Strategies
The Power of Experience

Maintaining Public Sector Funding Access:

The Importance of Preserving Money Market Mutual Funds (MMFs)

New MMF regulations, taking effect in October of this year, are having major negative consequences for issuers and borrowers of debt held by money market funds. Specifically, Tax-Exempt MMFs (TE MMFs) are closing and assets are leaving. This is drying up a very important municipal financing conduit.

As TE MMF funds close (or shorten their maturities), municipalities have fewer buyers for their debt. Even when they are able to place issues with the remaining TE funds, due to the shortened maturity structure, they are less able to lock in rates and more subject to weekly rate resets. This increases volatility and adds to their borrowing costs. If they are not able to place their issues with TE MMFs, only two options are available. They must turn to other lenders that have higher transaction costs or charge higher rates or they must defer or cancel infrastructure, educational/healthcare facilities or other municipal projects.

This paper will show the following, all of which demonstrate the negative impacts on municipal financing of new MMF regulation:

- Tax-Exempt MMFs are closing
- Remaining TE funds are shortening maturities
- Managers that use TE funds on behalf of their customers are exiting those funds

We estimate specifically that 30 - 50% of these assets, which is the portion originating from non-retail investors, are likely to run off. This level of run-off will profoundly reduce the short-term market for municipal debt. They will snowball into more fund closures and further tighten the municipal short-term debt market. Without Tax-Exempt MMFs, municipalities will be forced to seek higher cost borrowing like bank credit, or reduce their short-term capital consumption. Projects in infrastructure, healthcare, education and government services will be impacted.

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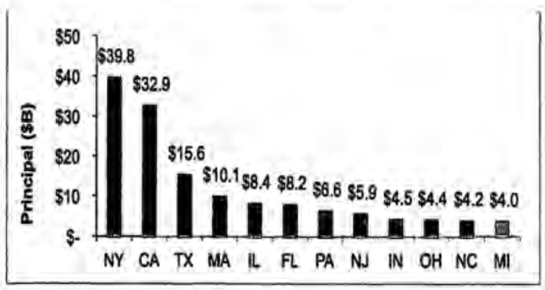
I. Background

MMFs have historically been an important holder of short-term municipal debt. As of December 2015, they provided nearly $250 billion of short-term funding to municipalities by purchasing their short-term debt instruments.

Figure 1 shows the large Tax-Exempt MMF investments in municipal debt of highly populated industrial and economic centers including New York, California, Texas, Massachusetts, Illinois, and Florida.

Figure 1. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States ($B), Source: CraneData.com, December 2015

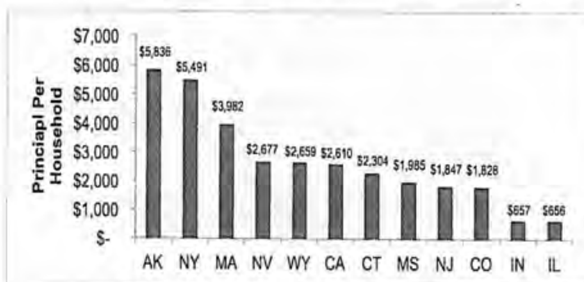


The reach of TE MMFs is even more striking when viewed in light of population. These funds represent over $700 for every man, woman and child in the U.S. That's up to $2,000 per household that will be lost if these funds shrink or disappear.

The impact is geographically diverse. The per capita effects are just as pronounced in Nevada, Wyoming, and Colorado as they are in New York and California.

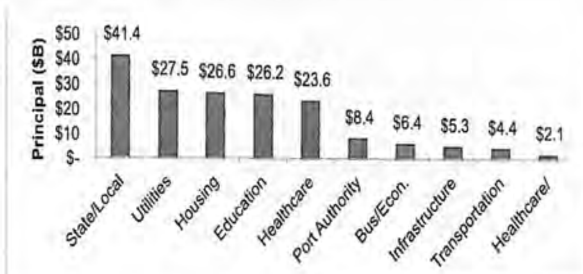
Figure 2. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States by Assets Per Capita, Source: CraneData.com (December 2015), U.S. Census

Figure 3. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt – Top 12 States by Assets Per Occupied Housing Unit, Source: CraneData.com (December 2015), U.S. Census, ACS



As Figure 4 illustrates, these funds help finance a wide variety of important public activities. Healthcare, housing, education, and utilities each have over $20B held by TE MMFs. If TE MMFs disappear or shrink, funding for all these sectors is at risk.

Figure 4. Tax-Exempt Money Fund Holdings of Short-Term Municipal Debt –Top 10 Sectors, Source: CraneData.com, December 2015 ($B)



Treasury Strategies

The Power of Experience

Figure 5, using Idaho as an example, illustrates the broad cross section of municipal issuers. As the table shows, TE MMFs support Idaho based healthcare, housing, industrial development, infrastructure and state and local governments. These issuers are at risk should funds continue to shrink or close.

Figure 5. Tax-Exempt Money Fund Idaho-based issuers, Source: CraneData.com, December 2015 ($B)

IDAHO		
Holding (12/31/15)	**Principal**	**Issuer Type**
IDAHO HEALTH FACILITIES AUTHORITY REVHOSPITAL (TRINITY HEALTH CREDITGROUP) SERIES 2013ID, 0.13%	10,100,000	Healthcare
Idaho Health Facilities Authority, (Series 2013ID), TOBs, (Trinity Healthcare Credit Group), 0.130%	22,805,000	Healthcare
IDAHO HOUSING & FIN ASSN	15,575,000	Housing
Idaho Housing & Finance Association Single Family Mortgage Revenue VRDO	7,615,000	Housing
IDAHO HOUSING AND FINANCE ASSOCIAT	5,850,000	Housing
IDAHO HSG & FIN ASSN NONPROFIT FAC	17,180,000	Housing
IDAHO ST HSG & FIN ASSN SF MTGE	8,935,000	Housing
IDAHO ST HSG & FIN ASSN SF MTGE REVENUE	21,295,000	Housing
Lenexa Multi-family Hsg. Rev. (Meadows Apts. Proj.) Series A, LOCFannie Mae VRDN	13,865,000	Housing
CASSIA CNTY IDAHO INDL DEV CORP REVIDB & PCR (EAST VALLEY CATTLE LLC)SERIES 2006 (LOC: COOPERATIEVECENTRALE RAIFFEISEN-BOERENLEENBANKBA), 0.05%	7,000,000	Industrial
CASSIA CNTY IDAHO INDL DEV CORP REVIDB & PCR (OAK VALLEY HEIFERS LLC)SERIES 2007 (LOC: COOPERATIEVECENTRALE RAIFFEISEN-BOERENLEENBANKBA), 0.05%	1,800,000	Industrial
Idaho Eagle Industrial Development Corps.	1,830,000	Industrial
Power County, ID IDC (J. R. Simplot Co.), (Series 2012) Weekly VRDNs,(Rabobank Nederland NV, UtrechtLOC), 0.050%	35,000,000	Industrial
Ammon Idaho Urban Renewal Agy Var-Tax Increment-Se	1,145,000	Infrastructure
Idaho Building Authority Revenue (Prison Facilities Project) VRDO	31,215,000	Infrastructure
IDAHO ST BLDG AUTH BLDG REV	7,370,000	Infrastructure
COEUR D ALENE IDAHO	10,000,000	State / Local
IDAHO ST	180,000,000	State / Local
Idaho St Tans	15,550,000	State / Local
IDAHO ST TAX ANTICIPATION NOTE	19,000,000	State / Local
IDAHO STATE OF GO Tax Anticipation NoteSERIES 2015, 2.00%	75,000,000	State / Local
Idaho TAN	60,000,000	State / Local
State of Idaho	37,200,000	State / Local
GRAND TOTAL:	605,330,000	

Treasury Strategies

The Power of Experience

II. Tax-Exempt MMFs have been closing at an increasing rate

Since the announcement of the final rule in 2014 with a target implementation of October 2016, 40 Tax-Exempt MMFs have closed or announced they will close. That process has a double impact. The pace of closures is accelerating. These funds are no longer in a position to buy new municipal debt, thereby shrinking the market and also putting upward pressure on borrowing costs.

The funds that are closing have a wide reach as shown in Figure 6:

- They account for approximately $14.4B in short-term municipal debt holdings.
- The pace of closures is increasing as implementation nears; almost twice as many funds closed in first quarter 2016 as in all of 2015.
- Many closed funds were state-specific. This means the impact of their closing is concentrated in states with multiple and large municipal debt issuers.
- Several major managers, including Deutsche Bank, Goldman Sachs and JP Morgan Chase, have significantly scaled back or exited the Tax-Exempt MMF business altogether.

Figure 6. Funds Closed in 2015-2016 or Closing in 2016

Fund Closures (Oct 2015 – Apr 2016)		
Fund	**Principal ($B)**	**Year Closed**
BofA T-E Reserves	3.70	2016
UBS RMA Tax-Free Fund	2.91	2016
UBS Select Tax-Free Capital Fund	1.54	2016
RBC T-F MMF	1.06	2016
BofA Municipal Reserves	1.05	2016
UBS RMA California Municipal Money Fund	1.02	2016
Putnam Tax-Exempt Fund	0.90	2016
UBS RMA New York Municipal Money Fund	0.75	2016
Reich & Tang CA Daily T-F	0.71	2015
Reich & Tang DIF Muni	0.63	2015
Western Asset Inst AMTFree Muni	0.62	2015
PNC Tax Exempt Money Market Fund	0.57	2016
Dreyfus NY AMT-Free Muni MMF	0.41	2015
BofA CA Tax-Exempt Reserves	0.40	2016
BofA NY Tax-Exempt Reserves	0.29	2016
State Street Instit T-F MMF	0.20	2015
Goldman Sachs FS Tax-Exempt CA	0.18	2016
Touchstone OH T-F MMF	0.17	2015
Alpine Municipal MMF	0.12	2015

BofA MA Muni Reserves	0.11	2016
Goldman Sachs FS Tax-Exempt NY	0.09	2016
Dreyfus BASIC NY Muni MMF	0.09	2015
Dreyfus NY AMT-Free MuniCashMgt	0.09	2015
Dreyfus BASIC Muni MMF	0.07	2015
BofA CT Muni Reserves	0.05	2016
BlackRock NC Muni MMP	0.05	2015
Putnam Tax-Exempt Money Market Fund	0.04	2016
Deutsche NY Tax Free Money Fund	0.03	2016
Touchstone T-F MMF	0.03	2015
BlackRock NJ Muni MMP	0.02	2015
BlackRock VA Muni MMP	0.02	2015
Western Asset CT Muni MMF	0.02	2015

Figure 7 highlights the impacts on individual issuers embedded in these TE MMF closings. For example:

- The Illinois Finance Authority and New York State Dormitory Authority are large issuers that provide low-cost financing to public agencies and non-profits. Each has issued $200M+ in debt that is being held by TE MMFs that are closing.

Figure 7. Largest Individual Issuers of Short-Term Municipal Debt Impacted by 2016 Fund Closings ($M)

Issuer	Principal ($M)
Illinois Finance Authority	267
New York State Dormitory Authority	219
New York City, NY Municipal Water Finance Authority	163
California Health Facilities Financing Authority	156
New York State Housing Finance Agency	154
City of Rochester, MN	145
California Statewide Communities Development Authority	142
City & County of Denver, CO	129
Missouri State Health & Educational Facilities Authority	113
New York City, NY Housing Development Corp.	109

Figure 8 highlights the impacts on specific states embedded in these TE MMF closings.

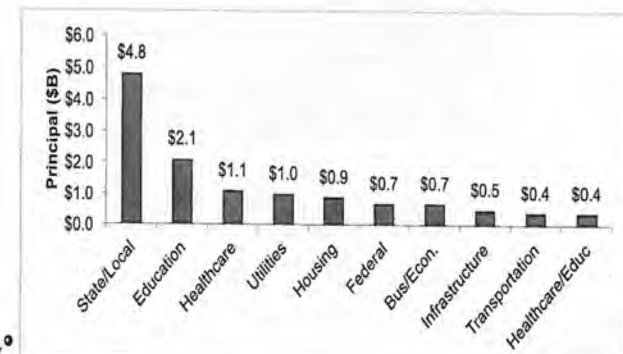
- New York, California, and Texas each have $1B+ in issues held in funds that are closing

Figure 8. States Most Impacted by 2016 Fund Closings – Top 12 States ($B) Source: CraneData.com, December 2015 ($B)

Figure 9 highlights the impacts on the sectors embedded in these TE MMF closings.

- Education, healthcare, utilities and housing sectors all have over $1B+ of issues in funds that are closing, nationwide

Figure 9. Industry Sectors Most Impacted by 2016 Fund Closings – Top 10 Sectors ($B) Source: CraneData.com, December 2015 ($B)



III. TE MMFs are shortening portfolio maturities

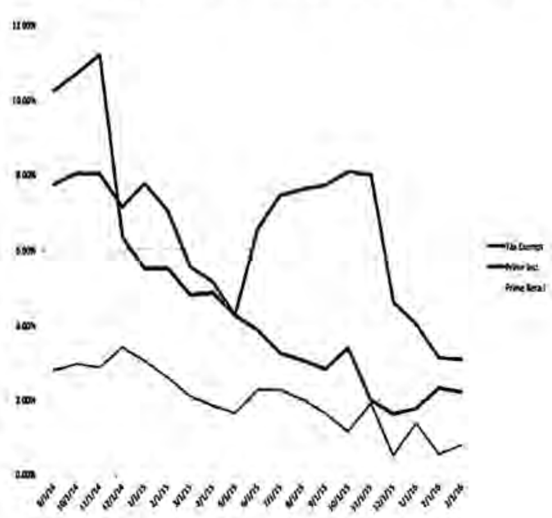
Fund companies are anticipating further investor redemptions as they approach the October 2016 rule implementation. To prepare for asset run-off, they are scaling back buying municipal debt in the all important six- to twelve-month maturity range.

In our consulting practice, we have encountered municipalities that have struggled to issue debt with longer than six-month maturity. Our direct experience includes a school district and a bridge commission. This supports the notion that funds want more liquidity on hand to redeem investors expected to exit Tax-Exempt MMFs as October 2016 approaches.

Portfolio holding data confirms the anecdotal evidence. Tax-Exempt MMF managers are shortening their portfolios around the implementation date. In March 2016, six-month or longer securities in TE MMFs were less than a third of September 2014 levels (3% vs. 10%).

This is more pointed when compared to Prime Retail or Prime Institutional funds, especially over the most recent four months. Not surprisingly, Prime Institutional funds, which are also impacted by the rules, saw a similar decline. Prime Retail funds – those least impacted by the new regulations – declined the least of these fund types.

Figure 10. Portion of MMF Portfolio Holdings with Six-Month or Longer Maturity



IV. Managers using TE funds on behalf of their customers are exiting

As they formulated the new MMF rules, regulators believed Tax-Exempt MMFs were held almost exclusively by retail investors. This was important, because the new rules were aimed at what are commonly called institutional funds – those used by corporates, institutions and trusts (called non-natural persons).[1]

The thinking was that if these non-natural persons did not invest in Tax-Exempt MMFs, then TE funds would see little impact, and municipal finance would be unharmed. However, this key assumption is incorrect. Not only are **significant portions of Tax-Exempt MMFs held by non-natural persons,** but the business is already adjusting in ways that will hurt municipal borrowers.

To delve into this issue, we conducted a two-part examination:

- First, we had discussions with managers from six of the largest U.S. tax-exempt fund companies that collectively represent 60% of all such assets.
- Second, to validate those findings, we surveyed 21 financial intermediaries that invest in TE MMFs, including nine of the 50 largest U.S. banks.

Fund Managers
From discussions with fund managers, we have estimated that non-natural persons hold a material portion – at least 30% to 50% – of TE MMF assets. Only one manager thought its fund had less than 30% institutional ownership.

Fund managers tell us they expect that virtually all such non-natural person investors in Tax-Exempt funds to leave. Reasons given range from operational difficulties to investment policy restrictions, driven primarily by the new regulations. As the new rules force such investors to exit, Tax-Exempt MMF asset levels will shrink and many funds will close.

Figure 11. Estimated TE MMF Assets Held by Institutional Investors, Source: Treasury Strategies Interviews of Top Fund Managers, February 2016

Fund Manager	Estimated % of TE MMF Assets Owned by Institutional Investors
# 1	30%
# 2	35%
# 3	15%
# 4	45%
# 5	50%
# 6	30%

[1] Non-natural persons include entities such as partnerships, LLCs, irrevocable trusts, corporations, and institutions

Financial Intermediaries
Information from Financial Intermediaries (FIs), who direct customer investments into Tax-Exempt MMFs, also paints a troubling picture for the future of these funds. Tax-Exempt MMF usage by FIs is likely to plummet.

According to FIs, non-natural persons account for almost two-thirds of the assets that they place in Tax-Exempt MMFs. Many FIs plan to cease offering Tax-Exempt Funds to any client, due to the complexity, difficulty and risk of determining which clients are natural versus non-natural investors. For others, the new rules make it impossible to continue offering Tax-Exempt funds to customers as an option on their sweep platforms. Accordingly, FIs will fully or substantially eliminate their use of Tax-Exempt MMFs on behalf of their customers.

This is a double-edged sword for municipal finance. First, lower investment in Tax-Exempt MMFs translates directly to reduced outlets for municipal borrowing. Secondly, at these significant levels of asset reduction, many TE funds will fall below efficient operating levels, and will close entirely – a trend we have already noted is underway.

V. Conclusion

New SEC rules that change how MMFs function are having many unintended consequences. One such consequence now manifesting itself is a material reduction in the short-term credit available to municipal borrowers whose debt is held by Tax-Exempt MMFs.

As recently as mid-2015, Tax-Exempt MMF assets exceeded $250B. As market participants prepare for new regulations to become effective, TE funds are closing at an increasing rate, Financial Intermediaries are pulling customers out of TE funds, and sweep products are eliminating TE funds as an investment option.

30 - 50% of these assets, which is the portion originating from non-retail investors, are likely to run off. This level of run-off will profoundly reduce the short-term market for municipal debt. They will snowball into more fund closures and further tighten the municipal short-term debt market. Without Tax-Exempt MMFs, municipalities will be forced to seek higher cost borrowing like bank credit, or reduce their short-term capital consumption.

PREPARED STATEMENT OF MICHAEL J. AROUGHETI

COCHAIRMAN OF THE BOARD OF DIRECTORS, ARES CAPITAL CORPORATION, ON BEHALF OF THE SMALL BUSINESS INVESTOR ALLIANCE

MAY 19, 2016

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Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee on Securities, Insurance and Investment, my name is Michael Arougheti and I am the Co-Chairman of the Board of Directors of Ares Capital Corporation, an SEC-registered business development company, or BDC, and one of the largest non-bank providers of capital to small- and medium-sized American companies; the backbone of the U.S. economy. I appreciate the opportunity to testify today on behalf of the Small Business Investor Alliance (SBIA), a trade association which represents a majority of the nation's BDCs. SBIA's BDC members provide vital capital to small and medium-sized businesses nationwide, resulting in job creation and economic growth. Since the SBIA was established in 1958, our mission has been to ensure a healthy and vibrant market for small and mid-size businesses.

Background on Ares Capital Corporation

Ares Capital Corporation is publicly-traded on The NASDAQ National Market and is currently the largest publicly-traded BDC by both market capitalization and assets. Since our initial public offering in 2004, we have invested more than $20 billion in over 650 transactions involving hundreds of small and medium sized American companies. In the process, we have created tens of thousands of new jobs and provided capital to growing businesses that were unable to access capital through commercial banks or other traditional financing sources.

The BDC Sector is Growing and BDCs are a Positive Force in Providing Capital to Small and Mid-Size Businesses

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". Specifically, Congress created BDCs in 1980 to enhance capital access to small- and medium-sized businesses. Uniquely, the BDC model gives ordinary investors the opportunity to finance small and medium size companies – effectively "Main Street funding Main Street". BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to access capital from traditional sources such as banks. Despite an outdated regulatory regime which has been in place since the early 1980s, the number of BDCs has grown significantly. This growth accelerated following the economic downturn after the 2008-2009 economic recession, where BDCs addressed the needs of small and medium-sized businesses that were starved for capital. Currently, there are over 80 BDCs in the United States and BDC loan balances have more than tripled since 2008.

BDCs Increasingly Filling Void Left by Banks in Middle Market Lending

While the scope of BDC's investments may vary, all BDCs share a common investment objective of improving capital access to small and medium-sized companies. Today, the middle market sector of the economy is responsible for one-third of private sector GDP[1] and BDCs have

[1] Source: National Center for the Middle Market: http://www.middlemarketcenter.org/infographics/1q-2016-middle-market-indicator-infographic

grown as commercial banks have withdrawn from lending to this sector. As commercial banks and other traditional financing sources continue to retrench from the business of providing loans to small and medium size companies, BDCs now find themselves at the forefront of the effort to address the unmet capital needs of these companies. The dramatic decline in bank financing for middle market loans has been a long term trend. Middle market borrowers have historically depended on smaller, regional banks for financing, and the number of these banks has been shrinking since the 1990s. In order to continue to provide sufficient access to capital for small- and medium-sized companies, modernization of the BDC regulation is essential. Indeed, modernization will permit BDCs to meaningfully grow and serve these businesses. In an appendix to our written testimony, we have provided some helpful charts to demonstrate the changes in the capital markets landscape and the retrenchment of traditional banks from lending to these businesses.

SBIA Member Investments Across the United States

SBIA's BDC members have invested in numerous small and mid-size companies throughout the United States. According to AdvantageData, as of March 31, 2016, BDC aggregate loan commitments in the United States equaled over $82 billion[2], and the top sectors include: $24 billion in the services sector, $17 billion in manufacturing, $13 billion in finance, insurance & real estate, $6 billion in mining, and $6 billion in transport, communication and electric/gas.[3]

To provide an example of the type of investment made by BDCs, Ares Capital Corporation invested in OTG Management, Inc., a founder-owned operator of full service sit-down and quick service restaurants, bars, lounges, gourmet markets, and news and gift shops based in airports in the U.S. and Canada. OTG was awarded a contract to build out and operate the food and beverage concessions at JetBlue's new Terminal 5 at New York's JFK International Airport and needed to raise capital to complete the construction plan. However, OTG was a small company with limited operating history at the time and consequently, was unable to obtain financing from traditional senior debt providers or private equity firms. Ares stepped in to fill this void and provided OTG with much-needed capital as well as management expertise and support to help OTG continue to grow its business.

Ares has also helped fund the growth of minority owned and operated businesses, including ADF Restaurants, which is the second largest Pizza Hut franchisee in the country with over 250 locations in the Northeast.

Similarly, Main Street Capital Corporation (NYSE:MAIN), an SBIA member BDC based in Houston, Texas, has funded two of the fastest growing technology companies (IDX and CBT Nuggets) in Eugene, Oregon; the largest privately-owned jewelry store chain in the Rocky

[2] Source: AdvantageData, *Business Development Company (BDC) Commitment to the United States Middle Market*, Q1 2016
[3] *Id.*

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Mountains (Jensen Jewelers), headquartered in Twin Falls, Idaho; and the leading fixed base operator (FBO) (Indianapolis Aviation Partners) at the Indianapolis airport.

BDCs have numerous strategies, including investing in early-stage companies. For example, Hercules Capital, Inc. (NYSE: HTGC), an SBIA member BDC based in Palo Alto, California (with secondary offices in Boston, Massachusetts) focused on early-stage/venture businesses, has funded four early-stage businesses in Virginia, including Intelliject (Richmond), a specialty pharmaceutical company making auto-injecting technology for vaccines; and four telecommunications companies, including Mobile Posse (McLean) which has a mobile advertising solution, Rivulet Communications (Herndon) which focuses on IP network delivery, and Spring Mobile Solutions (Reston) which provides wireless solutions for corporate customers in Latin America.

BDCs are Highly Regulated and Provide Transparency to Investors

BDCs are heavily regulated by the SEC and appropriately, the activities of BDCs are fully transparent to regulators, investors and portfolio companies. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. These disclosure and other regulatory requirements are extensive and include, among other things, a requirement that BDCs publish a quarterly summary of each investment held by a BDC and the fair value of such investment. This is a significantly greater degree of transparency than that found in other financial services models.

The Need for Regulatory Modernization and Implementation through H.R. 3868, the Small Business Credit Availability Act

While BDCs are appropriately subject to extensive oversight and disclosure requirements, the Great Recession revealed certain inefficiencies in the BDC regulatory regime. To that end, the industry has been working with the SEC and Congress to develop legislation that would enable BDCs to expand their scope and do more to fulfill the BDC industry's policy mandate. These efforts have raised the question of how BDCs can fulfill their Congressional mandate of being an active provider of capital to small and medium sized companies, while remaining appropriately regulated and transparent? The answer – begin the process of modernizing the regulatory framework with a handful of modest, common sense changes. Clearly, the world is a much different place than it was in 1980 when Congress created BDCs.

While we certainly believe in the importance of appropriate regulation, many of the challenges faced by BDCs in increasing the amount of capital that they can raise and deploy are a consequence of where BDCs sit in the regulatory framework. BDCs are more akin to operating companies such as banks and other commercial lenders, yet are regulated as mutual funds.

Recognizing these challenges, the House Financial Services Committee recently passed HR 3868, the *Small Business Credit Availability Act*, with a strong bipartisan vote of 53-4. This bill was specifically designed to modernize the BDC sector precisely to enhance the ability of BDCs to provide capital to growing middle market companies as banks retreat from this sector, while simultaneously ensuring significant investor protections specifically requested by the SEC. **It is also important to note that BDCs are not seeking any government or taxpayer support or subsidy.**

1. Modest Increase in the Asset Coverage Ratio, with Investor Protections

Currently, most BDCs maintain an average leverage ratio of 0.5x-0.75x, reflecting a desire and a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep drop in asset values. This practice is driven in part by the requirement that BDCs "mark-to market" the value of their portfolio companies, which can erode the fair market value of a BDC's holdings due to negative changes in the broader loan market, irrespective of the actual financial performance of such portfolio companies. The maintenance of this cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress to provide capital to small and mid-sized businesses. More room under the asset coverage test will allow an additional cushion for shareholders and will provide BDCs with the ability to deploy more capital in the ordinary course of business and through market cycles. It would also, somewhat paradoxically, allow BDCs to **mitigate risk** by enabling them to invest in lower-yielding, senior assets that don't currently fit their economic model of requiring distributions to shareholders of at least 90% of their net income. In fact, the current asset coverage test actually forces BDCs to invest in riskier, higher-yielding securities in order to meet its RIC distribution requirements. H.R. 3868, in addressing this issue, permits a modest increase in leverage from 1:1 to 2:1, much less than the typical 10:1 ratio found in traditional banking institutions and on par with the 2:1 ratio under the current SBIC Debenture program, but without government guarantees or implied taxpayer subsidy. The legislation also includes significant investor safeguards for accessing additional leverage, including a shareholder vote or independent board of directors vote with a 12 month "cooling off" period. In turn, these protections will ensure that a BDC's shareholders will be able to decide whether they want to continue to hold shares of a BDC that plans to access additional leverage.

2. Offering Reforms Will Streamline Burdensome Paperwork & Reduce SEC Staff Time

BDCs often have a very narrow window in which to access capital markets. Yet BDCs are the only seasoned issuers required to still comply with certain provisions of the Securities Act which makes raising capital cumbersome and inefficient. For example, BDCs are not permitted to "incorporate by reference", thereby requiring them to file more paperwork than other issuers, which provides no benefit to investors. H.R. 3868 will provide relief through a variety of offering reforms which will reduce unnecessary paperwork, allow for increased research coverage and oversight of the sector for investors, and allow BDCs to raise capital for effectively.

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3. **Other Provisions**

The legislation also includes other provisions. These include: (1) allowing for the issuance of multiple classes of institutional preferred stock while maintaining one class of retail shares with all of the traditional shareholder protections which, in turn, would create additional flexibility for BDCs to raise additional capital in the face of difficult economic conditions while still addressing the SEC's concerns that preferred stock continue to be treated as debt for purposes of the asset coverage test, (2) permitting BDCs to own registered investment advisers, which BDCs already regularly receive permission from the SEC to own; and (3) allowing for additional investments in financial corporations such as small business equipment leasing companies. With respect to this last point, let me be clear that the modest amendments included in the bill would NOT increase a BDC's ability to invest in securities of private equity funds, hedge funds, collateralized loan obligations or other private funds.

In closing, we believe that the time is right to modernize regulations governing BDCs and pass legislation, which would allow BDC's to increase capital flows to America's small and medium size companies, spur economic growth and create jobs. It is clear that banks have left this space and will not return.

Small and medium sized businesses are the engine of our economy. Unfortunately, many traditional sources of capital are no longer available to help support their growth. This bill in my judgement represents a strong and necessary effort to modernize the BDC sector, so it can maintain and grow its participation in a growing small and middle market without reducing any investor protections.

I am happy to answer questions about the bill or any other matters, and on behalf of the SBIA and the BDC industry, I want to again thank the Committee for its commitment to increasing capital for growing businesses and especially its interest in the contribution of BDCs to the overall economy and job growth. We are hopeful that there will be a bi-partisan focus on this important initiative, and look forward to working with the sub-committee and the Senate in moving this bill forward.

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Biography of Michael J Arougheti

Mr. Arougheti is a Co-Founder of Ares and a Director and the President of Ares Management GP LLC, Ares' general partner. He is a Partner in the Ares Credit Group and a member of the Management Committee. He also serves as Co-Chairman and Executive Vice President of Ares

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Capital Corporation and as a director of Ares Commercial Real Estate Corporation (NASDAQ:ACRE).

Prior to joining Ares in 2004, Mr. Arougheti was employed by Royal Bank of Canada from 2001 to 2004, where he was a Managing Partner of the Principal Finance Group of RBC Capital Partners and a member of the firm's Mezzanine Investment Committee. Mr. Arougheti oversaw an investment team that originated, managed and monitored a diverse portfolio of middle-market leveraged loans, senior and junior subordinated debt, preferred equity and common stock and warrants on behalf of RBC and other third-party institutional investors.

Mr. Arougheti joined Royal Bank of Canada in October 2001 from Indosuez Capital, where he was a Principal and an Investment Committee member, responsible for originating, structuring and executing leveraged transactions across a broad range of products and asset classes. Prior to joining Indosuez in 1994, Mr. Arougheti worked at Kidder, Peabody & Co., where he was a member of the firm's Mergers and Acquisitions Group.

Mr. Arougheti also serves on the boards of directors of Investor Group Services, and Operation HOPE, a not-for-profit organization focused on expanding economic opportunity in underserved communities through economic education and empowerment.

Mr. Arougheti received a B.A. in Ethics, Politics and Economics, cum laude, from Yale University.

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Appendix to Testimony by Michael Arougheti, Ares Capital Corporation on
"Improving Communities and Business Access to Capital and Economic Development"

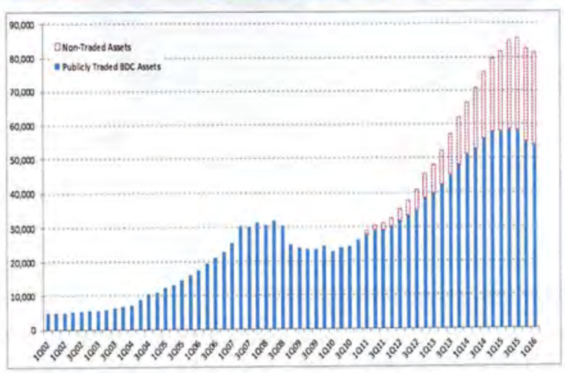
Appendix:

As an appendix to testimony provided by Michael Arougheti, Co-Chairman of the Board of Directors, President and Executive Vice President of Ares Capital Corporation, we provide the following data on the BDC industry, the retreat of banks in the middle market lending space, and a listing of current investments in the states of the members of the Subcommittee.

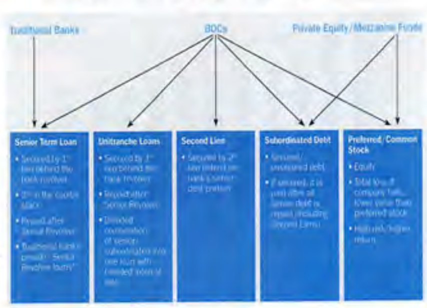
Information on Current BDC Industry Conditions:

The chart below shows the rapid growth of BDC assets (traded and non-traded) since 2002, illustrating the significant growth in BDC lending to middle market companies and the strong interest of investors to participate in this space.

Current BDC Assets in Millions as of 3/31/16



The chart below shows the types of lending engaged in by BDCs.

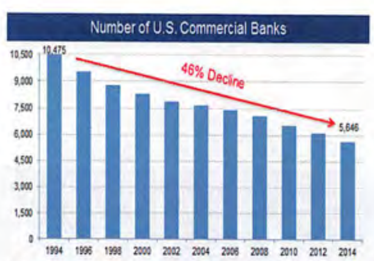


BDCs have provided significant investment to small and medium-size businesses across the United States, in almost every state, as illustrated in the map below.

Data Provided by Wells Fargo Securities, LLC

Decline of Bank Lending in Middle Market Sector

The following chart illustrates that as banks consolidate, the number of banks, and available credit for middle market businesses is shrinking.



Source: Federal Deposit Insurance Corporation, *Changes in Number of Institutions, FDIC-Insured Commercial Banks Activity 1934-2014*

Domestic banks have continued to play a less significant role in this space since 1997 as opposed to non-banks, as illustrated in the following chart from 1997-2012, showing the heavy role non-bank lenders, including BDCs, play in the middle market.

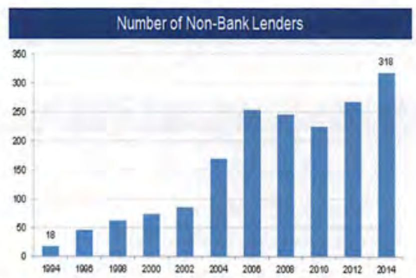
Middle Market																
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Domestic Bank	36.8%	40.0%	46.6%	53.6%	59.9%	52.2%	28.0%	13.0%	13.0%	15.8%	7.4%	14.8%	26.0%	16.0%	19.8%	12.2%
Finance Co.	7.6%	8.8%	11.8%	16.2%	17.7%	24.8%	39.5%	13.5%	11.0%	17.1%	13.0%	38.9%	34.8%	20.9%	22.6%	20.8%
Foreign Bank	25.1%	23.9%	18.1%	14.9%	16.0%	16.5%	6.5%	5.7%	6.9%	5.5%	6.8%	15.7%	6.3%	12.5%	9.6%	10.3%
Institutional Investors	25.7%	22.2%	19.9%	12.7%	3.8%	3.0%	25.6%	67.4%	64.7%	57.6%	67.2%	29.4%	30.3%	48.6%	45.5%	56.8%
Securities Firm	4.9%	5.0%	3.6%	2.6%	2.5%	3.5%	0.4%	0.3%	4.3%	4.1%	5.7%	1.2%	2.6%	2.0%	2.5%	0.0%

Source: S&P Capital IQ, Q4 2012 High-end Middle Market Lending Review.

This trend has only accelerated since 2012, with the share of non-bank lenders engaged in middle market lending increasing. Banks are increasingly ceding the market to non-banks such as BDCs.[1]

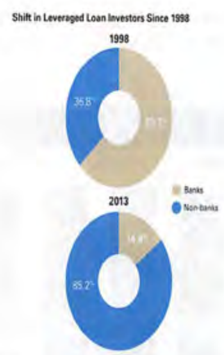
The number of non-bank lenders, including BDCs and other types of specialty finance companies has doubled since 2009, with Raymond James research indicating that this trend is expected to persist. In 2014, the average amount invested by these 318 lenders was $771.7 million, and the median $198.2 million.[2]

[1]Source: Bain Capital Credit, *Looking Forward*, July 2015: http://www.baincapitalcredit.com/insights/looking-forward
[2] Source: Raymond James, citing S&P Capital IQ Leveraged Commentary and Data



Source: S&P Capital IQ Leveraged Commentary and Data; Note: Includes investor groups that either participated in 3 or more loans or made $10 million of commitments

The chart below demonstrates the significant shift from bank lending to non-bank lenders. In 1998, banks made up 63.2% of the lenders in this space, reduced to only 14.8% in 2013.[3]



Examples of BDC Financings in Subcommittee Member States:

The following companies are examples of those companies invested in by SBIA member BDCs in the states of Subcommittee members:

Alabama:

[3] Source: Brown Brothers Harriman/Preqin, "Private Debt in 2015, Thinking Outside the Bank": https://www.bbh.com/blob/4096/226a51c6d04c412b68b6f9fa9426f3b5/private-debt-in-2015--thinking-outside-the-bank-pdf-data.pdf

Mspark, Inc. (Helena, Alabama) is a privately held, national provider of shared mail services. Each month the company delivers more than 30 million advertising packages to residential mailboxes in 27 states on behalf of 3,000 small and large business clients. Mspark reaches more than 22 million households with 98% penetration, using its micro-marketing strategies built upon segmentation, a means of targeting the right audience with the right value message. Using direct mail as the core promotional vehicle, mspark programs focus on driving results and optimizing ROI.

- **BDC Investment:** PennantPark Investment Corporation (SBIA Member, NASDAQ: PNNT)

Momentum Telecom, Inc. (Birmingham, Alabama) is a leading business communications provider, offering personalized cloud PBX solutions to direct subscribers and more than 300 partners nationwide. As the industry's most reliable provider, Momentum delivers superior voice quality backed by a geo-redundant network with 100% uptime. Momentum provides an array of services for both small and large businesses, including hosted VoIP, SIP trunking and unified communications services.

- **BDC Investment:** Medley Capital Corporation (SBIA Member, NYSE: MDLY)

Randall-Reilly Publishing Company, LLC (Tuscaloosa, Alabama) was founded in 1934, and evolved from the publisher of Who's Who to a marketing services company. Randall-Reilly offers data, media, and marketing services in order to help businesses target appropriate markets, connect with new customers through effective mediums, and engage prospects with tailored, relevant content. In addition to its general marketing expertise, Randall-Reilly has extensive experience with the Trucking, Construction/Equipment, Agricultural, and Printing markets.

- **BDC Investment:** PennantPark Investment Corporation (SBIA Member, NASDAQ: PNNT)

Idaho:

WBS Group, LLC (Hailey, Idaho) owns Marketron, the media industry's leading provider of business software solutions and services. Specializing in revenue management and audience engagement solutions, Marketron enables media companies to drive new growth opportunities by managing accounts and normalizing data in one, secure program. With more than 7,000 media organizations served, Marketron solutions are the most widely used in the world.

- **BDC Investment:** BlackRock Capital Investment Group (NASDAQ: BKCC) – **$47 MILLION**

Jensen Jewelers of Idaho, LLC (Twin Falls, Idaho) is a jewelry store chain, founded by Don and Mary Jensen in 1956. Jensen has grown from its first location in Twin Falls to fourteen stores across Idaho, Montana, Nevada, and Wyoming. Despite this growth, the company is still headquartered just down the street from where it began, and proudly employs over 100 people.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MAIN) – **$8 MILLION**

Guerdon Enterprises, LLC (Boise, Idaho) is a leading producer of large-scale modular construction projects, encompassing modular commercial buildings, single and multi-family housing, schools, hotels, remote work camps, military barracks, and tribal housing throughout the United States. With its primary factory and corporate office located in Boise, Guerdon is able to serve 10 western states.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MAIN) – **$13.4 MILLION**

Ohio:

Irth Solutions, Inc. (Columbus, Ohio) provides cloud-based, field service management software that helps organizations increase productivity of their field workforce. Irth Solutions helps companies by collecting and providing access to data in the field, automating and improving workflow processes, and increasing visibility and decision making abilities to improve performance. Irth Solutions is focused on field workforce programs that manage critical assets in the oil and gas, telecommunications, utilities, and renewable energy industries.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MSCA) – **$4 MILLION**

[4] All portfolio company data is compiled from public SEC records.

Roscoe Medical, Inc. (Strongsville, Ohio) designs, manufactures, and distributes an extensive line of high quality products for the home care environment. Roscoe offers wheelchairs, oxygen supply products, aerosol therapy devices, pain management products, bath safety devices, and much more. In 2013, Roscoe was included in the Inc. 5000 list of fastest-growing private companies in America.

- **BDC Investment:** Saratoga Investment Corporation (SBIA Member, NYSE: SAR) – **$4.3 MILLION**

The Step2 Company, LLC (Streetsboro, Ohio) is the largest American manufacturer of preschool and toddler toys and the world's largest rotational molder of plastics. Step2 offers an array of children's products, ranging from playhouses to push and pull wagons. Step2 employs over 800 full-time employees, and operates two manufacturing plants in northern Ohio.

- **BDC Investment:** Ares Capital Corporation (NASDAQ: ARCC) – **$42 MILLION**

Somerset Gas Transmission Company, LLC (Columbus, Ohio) is a privately held company which owns and operates a 266 mile natural gas pipeline originating in Cygnet, Ohio and ending east of Cleveland, Ohio. The company was formed in 1997 and is currently pursuing multiple opportunities to expand its pipeline and gathering assets to other parts of the country.

- **BDC Investment:** Rand Capital Corporation (NASDAQ: RAND) – **$786 THOUSAND**

Rhode Island:

CAI Software, LLC (Smithfield, Rhode Island) is a national leader in the delivery of quality Windows-based, Enterprise Resource Planning (ERP) software products and services across a broad spectrum of commercial and industrial markets, including: Building Materials and Millwork Manufacturing and Distribution, Seafood Processing and Distribution, Wholesale Food Processing and Distribution, Jewelry Manufacturing and Distribution, Consumer Goods Importing and Distribution, and the Precious Metals Refining and Manufacturing Industry. CAI's solutions are based on a scalable and extensible design that easily supports ever-changing industry regulations, data processing, and other business-specific requirements.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MSCA) – **$6 MILLION**

New York:

Cleveland BioLabs **Cleveland BioLabs, Inc.** (Buffalo, NY) is an innovative biopharmaceutical company that develops first-in-class pharmaceuticals designed to address diseases with significant unmet medical need. Cleveland's drugs span multiple stages of development, including treatments for various forms of cancer and the protection of healthy tissues from radiation, chemotherapy, or ischemic conditions.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$1.9 MILLION**

MEZMERIZ

Mezmeriz, Inc. (Ithaca, NY) develops projection technologies such as its unique MEMS module, which can be embedded into smartphones and mobile electronics to enable gesture UI, 3D depth photography, and interactive projection. This module projects large, high quality, daylight visible, vivid, color video that is always in focus and allows any nearby surface, wall, or table to become a large, interactive smartphone screen.

- **BDC Investment:** RAND Capital Corporation (SBIA Member, NASDAQ: RAND) – **$200 THOUSAND**

Niacet

Niacet Corporation (Niagara Falls, NY) is a leading global producer of propionates and acetates, chemicals used in the Food and Pharmaceutical Industries. The company has nearly 90 years of history in Niagara Falls, and owes its name to the combination of Niagara and acetylene. Among its many offerings, Niacet develops products for food preservation, antibiotic formulation, dialysis treatment, and energy production.

- **BDC Investment:** Apollo Investment Corporation (NASDAQ: AINV) – **$12.5 MILLION**

plated

DineInFresh, Inc. (New York City, NY) operates as Plated, a tech startup that provides pre-portioned ingredients for healthy, wholesome meals directly to a user's home. Plated combines an online platform with local food fulfillment centers to forge connections between farmers and the community by sourcing local meats, seafood, and vegetables in its shipments.

- **BDC Investment:** Ares Capital Corporation (NASDAQ: ARCC) – **$7.5 MILLION**

Virginia:

SOTERA DEFENSE SOLUTIONS

Sotera Defense Solutions, Inc. (Herndon, VA) is a mid-tier national security technology company that delivers innovative systems, solutions, and services in support of the critical missions of the Intelligence Community, Department of Defense, Department of Homeland Security, and federal law enforcement agencies charged with ensuring the safety and security of our nation. Sotera focuses on delivering essential counterterrorism, cyber security and operations, intelligence, data analytics, and C4ISR solutions to its customers throughout the national security community.

- **BDC Investment:** PennantPark Investment Corporation (SBIA Member, NASDAQ: PNNT) – **$17 MILLION**

Mobile Posse, Inc. (McLean, VA) helps small business leaders communicate with large audiences in an engaging and motivating manner that spurs innovation, increases operating efficiency, and drives revenue. InXpo accomplishes this by combining next-generation digital broadcasting platforms with its experience in audience engagement, learning strategies, data integration, creative consulting, event management, and even video capturing services.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$1 MILLION**

Deltek, Inc. (Herndon, VA) delivers leading enterprise software and information systems for project-based businesses. Deltek's software includes cloud-based solutions for market research and analysis; financial, resource, and human capital management; government compliance; and social collaboration efforts.

- **BDC Investment:** TCP Capital Corporation (SBIA Member, NASDAQ: TCPC) – **$15.1 MILLION**

Kaléo, Inc. (Richmond, VA) develops, markets, and sells branded pharmaceutical products and injectors to address health issues ranging from allergic reactions to opioid overdoses. To maintain user-friendly and effective products, the company employs Human Factor Engineering, a process of collaborating with patients to incorporate their needs into the product. Kaléo's innovations stem from its robust Intellectual Property portfolio, which includes 70 issued patents and 75 pending patents.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$1.3 MILLION**

New Jersey:

Education Dynamics, LLC (Hoboken New Jersey) is a prospecting service that provides marketing services and student acquisition solutions to institutions of higher education. Education*Dynamics* connects students with schools by helping admissions become more targeted and efficient. The company utilizes various marketing channels such as SEO traffic, display advertising, and social media in order to find high-quality prospects who are most likely to enroll and complete their degrees. Education*Dynamics* even contacts, vets, and submits potential students on behalf of school admissions offices.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$20.6 MILLION**

National Truck Protection Company, Inc. (Cranford, New Jersey) is the leading independent provider of warranty and service contracts to the North American trucking industry. NTP provides private label warranties to major Original Equipment Manufacturers (OEMs) as well as extended service contracts to the used truck sector. The company began in the early 1980's as a diesel repair center and has grown into an extended warranty provider, offering a suite of plans for truck protection.

- **BDC Investment:** Saratoga Investment Corporation (SBIA Member, NYSE: SAR) – **$9.5 MILLION**

American Sensor Technologies, Inc. (Mount Olive, New Jersey) manufactures pressure sensors and related products for use in water pressure, oil and gas, UHV and cryogenic, alternative energy mechanisms, and fluid power systems. AST offers semi-custom and custom pressure sensor designs which work within the design of embedded sensors as a part of an integral control system. The company was incorporated in New Jersey in 1997, and works closely with Macro Sensors in Pennsauken, a company AST acquired in 2005.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MAIN) – **$10.1 MILLION**

Massachusetts:

American Superconductor Corporation (Devens, MA) generates ideas, technologies, and solutions that meet the world's demand for smarter, cleaner energy. Through its Windtec Solutions, AMSC provides wind turbine electronic controls and systems, designs, and engineering services that reduce the cost of wind energy. Through its Gridtec Solutions, AMSC provides the engineering planning services and advanced grid systems that optimize network reliability, efficiency, and performance. The company's solutions are now powering gigawatts of renewable energy globally and enhancing the performance and reliability of power networks in more than a dozen countries.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$8.2 MILLION**

Joule Unlimited Technologies, Inc. (Bedford, MA) is pioneering a CO2-to-fuel production platform, which converts carbon dioxide, sunlight, non-potable water, and proprietary catalysts into ethanol, hydrocarbon fuels, or other chemicals. Joule combines advances in catalyst engineering with solar capture and process engineering to achieve levels of efficiency and scale that biomass operations cannot. The system works by pumping waste CO2 through a *SolarConverter* panel, where organisms in the catalyst consume the CO2, photosynthesize, and continually produce and excrete the desired product. Joule maintains a robust Intellectual Property portfolio of over 150 registered and pending patents that will allow the company to produce fuel for the future.

- **BDC Investment:** Ares Capital Corporation (NASDAQ: ARCC) – **$10 MILLION**

Gazelle, Inc. (Boston, MA) is an online marketplace for selling and purchasing used smartphones, tablets, laptops and accessories. Gazelle facilitates the recycling and reuse of electronics by its simple and quick process of exchanging electronics into cash or gift cards. Since its founding in 2006, Gazelle has received over 2 million trade-ins and paid out over $200 million.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$14 MILLION**

Indiana:

Boss Industries, LLC (La Porte, Indiana) is a leading manufacturer of rotary screw PTO compressor systems for utility and municipality markets. Boss operates a 50,000 square foot facility in La Porte that has production and design capabilities to serve its customers in multiple industries, including gas and electric utilities, municipal water and street departments, tire service and mechanic trucks, telecommunications, firefighting (Compressed air foam- CAF), fence contractors, rental, drilling and mining and military applications. Among its many offerings, Boss produces underdeck systems, hydraulic driven systems, tool lifts, airends for OEMs, and more.

- **BDC Investment:** TCP Capital Corporation (SBIA Member, NASDAQ: TCPC)

ARBOC Specialty Vehicles, LLC (Middlbury, Indiana) is a specialty vehicle company that manufactures low-floor buses with special angled and accessible entranceways in order to assist disabled passengers. ARBOC offers three, fully ADA compliant models: the Spirit of Freedom, the Spirit of Liberty, and the Spirit of Mobility.

- **BDC Investment:** Medley Capital Corporation (SBIA Member, NYSE: MDLY)

SonaCare Medical, LLC (Indianapolis, Indiana) is a pioneer of minimally invasive high intensity focused ultrasound (HIFU) technologies. SonaCare focuses on developing technologies for urological indications that offer precise and innovative procedures that can control cancer and significantly improve a patient's quality of life. The company has treated over 2,000 prostate cancer patients, and the results are documented in several peer-reviewed publications spanning 13 years of successful clinical outcomes.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC)

Pennsylvania:

The Neat Company (Philadelphia, PA) utilizes scanning technology to digitize and organize data, particularly from receipts, business cards, and invoices. Neat's cloud-based program captures information from scanned documents and makes the data searchable for easy navigation and analysis. Since 2002, Neat has helped eliminate data entry and allow businesses to find important information faster and easier than ever.

- **BDC Investment:** Hercules Technology Growth Capital, Inc. (SBIA Member, NASDAQ: HTGC) – **$19.5 MILLION**

Enerwise Global Technologies, Inc. (Kennett Square, PA) manages energy infrastructure and demand responses, as well as provides renewable energy services and technologies. Enerwise enables commercial and industrial customers to reduce energy consumption and costs, improve energy infrastructure reliability, and make informed decisions regarding energy purchases and programs. Founded in 1980, the company currently manages and administers over 1600 megawatts of demand response and renewable energy.

- **BDC Investment:** TCP Capital Corporation (SBIA Member, NASDAQ: TCPC) – **$17.2 MILLION**

GENEX Services, Inc. (Wayne, PA) helps firms manage and control the medical, wage-loss, and productivity costs associated with claims in the workers' compensation, disability, automobile, and health care systems. The company is the nation's leading provider of integrated managed care services, and focuses on three critical areas: Workers' Compensation and Disability Management, Medical Cost Containment, and Social Security Representation.

- **BDC Investment:** Medley Capital Corporation (SBIA Member, NYSE: MDLY)

Tennessee:

Tin Roof Acquisition Company (Nashville, TN) owns and operates a music venue, bar, and restaurant located near Nashville's famed Music Row. Since 2002, Tin Roof has been known as "A Live Music Joint," and its stages have hosted the famous, the should have been famous, and everyone in between. Tin roof celebrates local musicians and aims to promote Nashville's best new artists and songwriters.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MSCA) – **$16 MILLION**

Censis Technologies, Inc. (Franklin, TN) provides a flexible portfolio of surgical instrument tracking options using a web-based, user-friendly platform. Census tracks surgical instrument inventory, notifies users of the dates and types of sterilization techniques used, and even alerts OR technicians if tools are unclean, incompatible, or missing. The Censis suite of scalable solutions allows customers to choose an appropriate mix of services, facilitating an increase in patient safety, OR productivity, tray accuracy, and successful surgeries.

- **BDC Investment:** Saratoga Investment Corporation (SBIA Member, NYSE: SAR) – **$12.7 MILLION**

City Gear, LLC (Memphis, TN) is a retailer and preferred Nike supplier focused on urban apparel and performance footwear. The company's distribution facility in Memphis serves its 91 stores in the Southeast and Midwest, operating under the City Gear, Deveroes, and Marty's brand names. These stores primarily sell to males between the ages of 14 and 30, and are located in closed-air shopping malls near urban communities.

- **BDC Investment:** Capitala Finance Corporation (SBIA Member, NASDAQ: CPTA) – **$16.7 MILLION**

Illinois:

Aircell Business Aviation Services, LLC. (Itasca, IL) operates as Gogo Aviation, and is a leading global aero-communications service provider, offering in-flight internet, entertainment, text messaging, voice and other communications-related services to the commercial and business aviation markets. Gogo has more than 2,100 commercial aircraft equipped with its services and partnerships with 10 major airlines. Gogo employs over 800 and is a factory option at every major business aircraft manufacturer.

- **BDC Investment:** PennantPark Investment Corporation (SBIA Member, NASDAQ: PNNT) – **$23.4 MILLION**

InXpo, Inc. (Chicago, IL) helps small business leaders communicate with large audiences in an engaging and motivating manner that spurs innovation, increases operating efficiency, and drives revenue. InXpo accomplishes this by combining next-generation digital broadcasting platforms with services that assist businesses with audience engagement, learning strategies, data integration, creative consulting, event management, and even video capturing services.

Kansas:

Collective Brands, Inc. (Topeka, KS) is the parent company for a powerful portfolio of well-known and popular national brands, including Payless ShoeSource, Champion athletic wear, and Airwalk footwear. Payless ShoeSource is the largest specialty family footwear retailer in the Western Hemisphere, offering a trend-right and comprehensive range of everyday and special occasion shoes and accessory items at affordable prices. Payless was founded in 1956, and continues its original self-select business model, combined with leading customer service to provide a fun and engaging shopping experience for its customers. Today, Payless is a privately-held company that employs more than 25,000 associates worldwide.

- **BDC Investment:** Medley Capital Corporation (SBIA Member, NYSE: MDLY)

KBK Industries, LLC (Rush Center, Kansas) is a leading oil recovery and storage specialist, deploying the industry's premier technology for separating oil and water. Customers throughout North America, including exploration companies, independent drillers, and SWD companies, rely on KBK to help them safely and economically store, separate, and recover oil and water. To accomplish this, KBK develops and produces high-efficiency Skim Tanks, Desander Tanks, Free Water Knockouts, Gunbarrels, and Storage Tanks. Further, KBK supports customers with all levels of the process, including engineering, delivery, system startup, training, and maintenance.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MAIN) – **$12.8 MILLION**

South Carolina:

VitAG Holdings, LLC (Beech Island, SC) is pioneering the next generation of biosolids recycling. VitAG is a specialty fertilizer company, which engages in the conversion of municipal biosolids into inorganic fertilizers. Its recycling technology brings together the wastewater and fertilizer industries to transform biosolids into slow release, organically-enhanced inorganic granular fertilizers. Based in Beech Island, the Company sells its fertilizers through distributors in the United States and internationally.

- **BDC Investment:** TCP Capital Corporation (SBIA Member, NASDAQ: TCPC) – **$7.7 MILLION**

Compact Power Equipment, Inc. (Fort Mill, SC) manages and markets commercial and light construction equipment. The company is comprised of two major components: Equipment Rental and Equipment Services. The rental component provides tools, trucks, and trailers with high quality towable rental equipment such as mini-skids, excavators, skid steers, trenchers, and chipper shredders. Complementing this, the service component offers knowledgeable, certified local technicians who provide cost reducing maintenance services for facilities, commercial equipment, and light construction equipment nationwide.

- **BDC Investment:** Main Street Capital Corporation (SBIA Member, NYSE: MAIN) – **$7 MILLION**

AGY Holding Corporation (Aiken, SC) is a world leader in composite fiber materials used in a range of markets including Electronics, Thermoplastics, Industrial, Aerospace, Recreational/Consumer, and Defense. AGY produces high performance materials in the form of glass fiber yarns and reinforcements, enhancing six properties: strength, impact resistance, stiffness, temperature resistance, fatigue resistance, and radar transparency. These products are strong enough for use in ballistic armor on army trucks or navy ship hulls, yet light enough for private aircraft.

- **BDC Investment:** TCP Capital Corporation (SBIA Member, NASDAQ: TCPC) – **$13.9 MILLION**

Nebraska:

Pen-Link, Ltd. (Lincoln, NE) provides Law Enforcement and Intelligence agencies with state-of-the-art software and systems for the collection, storage, and analysis of telephonic- and IP-based communications. Pen-Link's software and systems – Pen-Link 8, LINCOLN, and Xnet – are widely recognized as industry standards, with thousands of licensed Law Enforcement and Intelligence users in federal, state, and local agencies worldwide. Pen-Link systems are widely favored because they not only excel at intelligence gathering and live collection, but they also provide a powerful suite of reporting and analytical tools; the type of functionality that is essential in drilling down through today's extensive data sets to reveal relationships that might otherwise go undetected.

- **BDC Investment:** Saratoga Investment Corporation (SBIA Member, NYSE: SAR) – **$10.5 MILLION**

Roto Holdings, LLC (Lincoln, NE) owns and operates some of the largest rotational molding companies in the United States, including Snyder Industries, Inc. Snyder's custom rotomolding makes a wide variety of plastic articles for a broad group of industries and applications. Synder produces Industrial Tanks, plastic and steel Intermediate Bulk Containers (ICBs), Material Handling Bins, Insulated Containers, Dry Powder Bins, Agricultural Tanks, Septic Tanks and Cisterns, Water Tanks, Refuse and Recycling Bins, Medical Waste Containers, Petroleum Products, and more.

- **BDC Investment:** PennantPark Investment Corporation (SBIA Member, NASDAQ: PNNT) – **$13 MILLION**

PREPARED STATEMENT OF STEPHEN W. HALL

LEGAL DIRECTOR AND SECURITIES SPECIALIST, BETTER MARKETS, INC.

MAY 19, 2016

Introduction

Chairman Crapo, Ranking Member Warner, and Members of the Subcommittee, thank you for the opportunity to testify today on behalf of Better Markets. Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. Its goal is to help establish a stronger, safer financial system that is less prone to crisis and the need for taxpayer bailouts. Better Markets seeks to achieve these goals through regulatory comment, public advocacy, independent research, and litigation. Through these channels, we serve as a counterweight to the financial industry to help ensure that policy makers and regulators prioritize the interests of hardworking Americans over special interests.

Better Markets supports the goal of promoting and protecting capital formation for the benefit of the real economy but has serious concerns about all three of the bills that are the subject of this hearing. They would remove or weaken regulations aimed at protecting investors and maintaining financial market stability in the areas of money markets funds, real estate securitizations, and business development companies.

In my testimony, I'll describe the perspective that Better Markets brings to these issues; offer a general assessment of the deregulatory approach reflected in these measures; and highlight specific provisions in each of these bills that we believe would be harmful.

The Better Markets Perspective

Better Markets firmly believes that vibrant, fair, and stable capital markets are crucial to generating economic growth and prosperity for all Americans. We also believe that achieving these goals requires a strong regulatory framework. That framework must be capable of protecting investors to sustain their confidence in our markets and preserve their willingness to participate in capital formation. And above all, our regulations must limit systemic risk in our markets to avoid a recurrence of the type of devastating financial crisis that nearly destroyed our economy in 2008.

That crisis was the worst financial disaster since the Great Crash of 1929, and it produced the worst economy our Nation has seen since the Great Depression of the 1930s. It nearly destroyed our financial system, obliterating millions of jobs, triggering a tidal wave of home foreclosures, and wiping out the savings of countless American households. Small businesses were particularly hard hit. In 2008, for the first time in history, more businesses failed than were started. The costs have been staggering: tens of trillions of dollars in lost GDP and inestimable human suffering. [1]

And the crisis is still being felt today. Underemployment remains at almost 10 percent, 6.7 million homes are still underwater; median wages remain stagnant; and middle class Americans still struggle with $3.5 trillion in nonmortgage consumer debt.

The lesson is clear: Without effective rules, our financial system is susceptible to financial crisis, and financial crisis poses the single greatest threat to capital formation and economic growth, especially among small businesses. Strong regulation is thus essential for protecting and promoting capital markets that support the real economy and ensure long term economic prosperity.

General Concerns

The deregulatory approach in these bills raises a number of concerns. First, we question whether these measures will really help businesses and municipalities access the capital they need to expand and contribute to economic growth. Throughout its history, members of the financial services industry have opposed regulation based on confident predictions that regulatory safeguards applied to their activities will limit access to capital and stifle economic growth. In fact, however, these claims tend to be speculative, anecdotal, and ultimately unfounded. In this case, we haven't seen credible evidence that these bills will materially benefit our financial system or the larger economy.

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[1] Better Markets, "The Cost of the Crisis: $20 Trillion and Counting", (July 2015), available at *http://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.*

Second, if enacted, these bills will come with a heavy price. They will expose investors to an increased risk of loss. Inflicting harm on investors doesn't fuel the real economy, and it ultimately undermines the investor confidence that is so essential to a well-functioning capital market.

Of greatest concern, these bills would also lead us in the dangerous direction of increased systemic risk and a greater likelihood of financial crisis. For example, we know for a fact that money market funds and the securitization of real estate loans contributed heavily to the 2008 financial crisis. The floating net asset value (NAV) and the risk retention, or "skin in the game," requirements that will soon take effect are key regulatory reforms designed to reduce the risk that our financial system—and these markets in particular—will once again be thrown into chaos. The bills at the center of this hearing would repeal or weaken those reforms before they have been given a chance to work. As result, these bills would increase the prospects for another devastating financial crisis that would destroy our economic growth.

Perhaps the Financial Stability Oversight Counsel (FSOC) said it best when it issued its proposed recommendations on money market reform. At the top of their list was the floating NAV. The FSOC observed that by reducing the risk of runs on money market funds, their recommendations would decrease both the likelihood and severity of future financial crises.[2] It explained that because financial crises have such a profoundly damaging impact on economic activity and economic growth, "*reforms that even modestly reduce the probability or severity of a financial crisis would have considerable benefits in terms of greater expected economic activity and, therefore, higher expected economic growth.*"[3]

The bills we're discussing today are at odds with this approach. They would weaken regulatory safeguards, thereby increasing the probability of another financial crisis, while putting investors needlessly at risk. We believe they would be counterproductive.

S. 1802—Deregulation of Money Market Funds

S. 1802 would allow all money market funds (MMFs) to maintain a fixed net asset value. This provision would effectively repeal the SEC's 2014 rule requiring institutional prime and institutional municipal money market funds to adopt a floating NAV. But to ensure that money market funds remain stable, we actually need to apply more regulation in this area, not less. The bill is a step in the wrong direction.

MMFs Are Vulnerable to Destabilizing Runs

MMFs are susceptible to runs and when they do occur, the financial system can experience major disruptions that cripple the short-term credit markets. MMFs do not come with any form of reliable capital buffer or Government insurance that can mitigate the effect of a run. In addition, the MMF market is large, amounting to $2.7 trillion, and relatively concentrated. MMFs are highly interconnected with other financial institutions, and they are widely used by individuals, institutions, and businesses as cash management vehicles or as sources of credit. By virtue of these characteristics, MMFs present an ongoing risk of runs that can spread widely and rapidly throughout the financial system.

The financial crisis of 2008 made this threat painfully clear. In the most compelling example of run risk, the Reserve Primary Fund broke the buck on September 16, 2008, due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. Although that debt was only 1.2 percent of the fund's total assets, a run ensued when the fund sponsors declined to provide support. Within 2 days, investors sought to redeem $40 billion from the fund. This required the fund to dump tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemptions. This fire sale in turn depressed asset values, further weakening the fund.

The run quickly spread to the entire prime MMF industry, and during the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets. This industry-wide run caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, falling asset prices, and mounting redemption requests. The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program to guarantee money market funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis.[4] The entire $3.7

[2] Proposed Recommendations Regarding Money Market Fund Reform, 77 *FR* 69,455 (Nov. 19, 2012), at 69,481 (FSOC Release).

[3] Id. at 69,482 (emphasis added).

[4] See SEC Division of Risk, Strategy, and Financial Innovation, "Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher", at 12 (Nov. 30, 2012), available at *http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.*

trillion money market fund industry was backstopped, putting taxpayers on the hook for any losses.

The collapse of the Reserve Primary Fund was not the first time—or the last—when MMFs faced significant stresses and potential collapse. During the crisis, other money market funds experienced significant stress levels requiring their sponsors to provide support. Going further back in time, one study found 144 cases from 1989 to 2003 in which MMFs would have broken the buck had it not been for sponsor support. [5] Another survey revealed 78 instances between 2007 and 2011 in which sponsors provided support to their MMFs in the form of either cash contributions or purchases of securities from the fund at inflated prices. [6] Relying on sponsors to maintain a stable NAV is an unreliable approach, as we learned from the financial crisis.

As the SEC and the FSOC have concluded, requiring MMFs to maintain a floating NAV is one the most important reforms we can adopt to reduce this run risk. Under this approach, instead of being fixed artificially at $1.00, the price of shares fluctuate and reflect the actual market value of the assets in the fund portfolio.

The Floating NAV Mitigates Run Risk

Floating the NAV offers several benefits. First and foremost, it reduces the incentive of any investor to expedite withdrawals from a stressed MMF in hopes of redeeming at the $1.00 price as opposed to something lower. [7] Investors who withdraw first no longer benefit from a "first mover advantage," since they receive the actual market-based value of their shares. Eliminating this first mover advantage substantially reduces run risk.

Second, the floating NAV also promotes greater fairness among investors. [8] As a result of the artificially stable NAV, an investor that succeeds in redeeming early in a downward spiral may receive more than they are due by liquidating at $1.00 per share even though the underlying assets are actually worth less. Without a sponsor contribution or other rescue, that differential in share value is paid by the shareholders remaining in the fund. Early redeemers receive a windfall and later redeemers pay the cost. The floating NAV eliminates this disparity and unfairness.

Finally, floating the NAV also enhances transparency. A fluctuating NAV helps correct the basic misconception among many investors that their MMF investment cannot lose value. Instead, investors see plainly that they bear the risk of loss as to MMFs, just as they do with other investment vehicles. Acclimating MMF investors to share price fluctuations would further mitigate their tendency to run in panic at the prospect that their MMF will "break the buck." [9]

Prospectus Disclosure Is Insufficient

S. 1802 includes a provision apparently aimed at preserving the transparency benefits of the floating NAV. The bill would prohibit bailouts of money market funds and require prominent disclosure of that fact in all fund prospectuses and sales literature. It thus seeks to correct the widespread misimpression that MMFs cannot sustain losses or that they carry bank-like deposit insurance. However, we do not believe that disclosure alone would alter investors' inflated confidence in the stability of MMFs. Demonstrating the truly variable nature of MMFs on a day to day basis through transparent price fluctuations would be far more persuasive than simply stating the fact in fine print disclosure forms. More importantly, this provision in the bill would do nothing to mitigate the powerful incentive to redeem shares that arises directly from the fixed NAV. Nor would it eliminate the unfair advantage that some investors can gain by redeeming shares early in times of stress under a fixed NAV.

The concerns expressed by opponents of the floating NAV are understandable but not persuasive. The operational changes required by the SEC rule appear to be manageable, in part because the SEC established a 2-year compliance period. Most of the large fund complexes have made the necessary adjustments to implement the

[5] Moody's Investors Service, Special Comment, "Sponsor Support Key to Money Market Funds" (Aug. 9, 2010), available at *http://www.alston.com/files/docs/Moody's_Report.pdf*; see also Release at 69,462 n. 28.

[6] See Steffanie A. Brady, et al., Federal Reserve Bank of Boston, Risk and Policy Analysis Unit, "The Stability of Prime Money Market Mutual Funds: Sponsor Support From 2007 to 2011", Working Paper RPA 12-3, at 4 (Aug. 13, 2012), available at *http://www.bos.frb.org/bankinfo/qau/wp/2012/qau1203.pdf*; see also SEC Press Release, supra note 10, at 4 (citing over 300 instances since the 1980s of sponsor support necessitated by the diminished value of holdings or extraordinary redemptions).

[7] Money Market Fund Reform; Amendments to Form PF; Proposed Rule, 78 *FR* 36,834 (June 19, 2013), at 36,850.

[8] Id.

[9] Id. at 36,851.

rule. And Treasury and the IRS have addressed the tax and accounting concerns previously raised.

Loss of Institutional Investment Will Not Be Significant

Perhaps the single greatest lingering concern is that institutional investors will migrate away from floating NAV Funds, especially the municipal MMFs, raising the cost of credit for local governments. Under the SEC rule, however, the impact is not expected to be significant. As it is, institutional investors account for a small percentage of municipal debt in the money market space, and at least some institutional investors will continue to seek the tax benefits that municipal funds provide. In addition, municipal MMFs that serve retail investors will not be subject to the floating NAV requirement, so the feared reduction in investment will not occur in that sector.

In any case, even if the cost of credit rises to some degree for businesses or municipalities, the gains in terms of systemic stability will be worth it. Policy makers responsible for mitigating systemic risks must at times face the need to "accept higher costs in normal times in order to significantly reduce the costs of financial crises."[10]

In short, repealing the SEC's rule requiring institutional prime and municipal MMFs to float their NAV is a step backward. In reality, we should be floating the NAV for all money market funds, not just institutional funds.[11] In addition, regulators should be weighing the need for additional safeguards, including capital buffers.[12] Rolling back the progress that the SEC has made in protecting MMFs from the potentially disastrous runs is unwise.

H.R. 4620—Risk Retention Exemption for Commercial Real Estate Loans

H.R. 4620 would weaken the risk retention safeguards applicable to securitizations of commercial real estate loans. If properly regulated, the securitization markets can be an important source of affordable credit. However, when the securitization process is marked by recklessness or fraud in the origination and pooling of the underlying financial assets, coupled with a lack of transparency and disclosure, then securitized loans can inflict enormous harm on the entire financial system.

Regulatory Gaps in Securitization Contributed to the Crisis

It was precisely this type of broken securitization market that contributed so heavily to the financial crisis. In the years leading up to the crisis, the "originate to distribute" model became pervasive in the residential mortgage market. Loans were originated for the express purpose of being sold into securitization pools, allowing lenders to reap enormous fees without bearing the credit risk of borrower default. This widespread practice ultimately led to the accumulation of massive amounts of high-risk mortgage-backed securities in the hands of financial institutions and investors of all types. The situation epitomized the very concept of systemic risk, and when the housing bubble burst, it took a huge toll on markets, investors, and the economy.

A similar pattern unfolded in the commercial real estate market, where underwriting standards sank to meet demand for loans that could be securitized. In fact, many banks that failed or were bailed out and rescued during the financial crisis did so in part because they held badly underwritten commercial real estate loans. The crisis devastated not only the residential mortgage backed securities market, but also the commercial mortgage backed securities market.

Risk retention requirements are among the most important reforms in this area. They are designed to align the interests of securitizers more closely with investors, thereby increasing the quality of assets in securitization pools and reducing the risk of loss. These requirements help protect investors and restore confidence in mortgage-backed securities. This in turn helps allocate capital to real estate development in a way that will support economic growth without threatening a financial crash. Diluting the risk retention requirements is the wrong approach.

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[10] FSOC Release, at 69,480 n. 119.

[11] As Better Markets detailed in this comment letter: Letter from Better Markets to the SEC, Money Market Reform (Release No. 33-9408) (Sept. 17, 2013). In our letter, we also explain why the SEC's MMF reforms, while critically important, were still only half-measures. In addition to floating the NAV for all MMFs, the SEC must apply other safeguards, including capital buffers, especially where the fixed NAV is allowed to persist.

[12] Id. at 2.

The Bill Would Create a Blanket Exemption for Single or Related Loans

H.R. 4620 would make two particularly worrisome changes in the risk retention rule. First, it would create a blanket exemption for the securitization of a single commercial real estate loan or groups of related loans. The exemption is unwarranted for several reasons. Even single loans and groups of related loans can represent large and complex transactions that present underwriting challenges. Moreover, securitizations of these types of loans can actually present heightened risks of default since the loan pools lack diversity and therefore concentrate risk. In addition, the securitization of a group of cross-collateralized loans poses greater risk, since the default of one loan triggers default of the entire pool. Therefore, the risk retention requirements still have an important role to play in incentivizing careful underwriting for a single loan or a group of related loans as these investments are assembled for sale to investors.

This exemption is also troubling because it is essentially unlimited. The bill would impose no boundary on the number, size, quality, or complexity of the loans that would fall within the exemption. Under the bill, groups could include any number of loans, provided that they have relatively tenuous connections through "related borrowers" and direct or indirect ownership of the underlying properties. Finally, the bill would leave no room for the agencies to impose any safeguards or objective risk-limiting requirements on such securitizations as a condition for the exemption. This restriction prevents the agencies from applying their expertise to the task of identifying commercial real estate loans that can be safely exempted from the risk retention requirement.

The Bill Would Weaken the Exemption for Qualified CREs

The bill would also dilute the protections in the risk retention rule applicable to qualified commercial real estate loans. These loans are exempt from the risk retention requirement provided they have certain attributes that make them relatively low risk. The risk retention rule currently specifies the features of qualified commercial real estate loans that make them eligible for the exemption. However, the bill would eliminate some of those features and actually prohibit the agencies from taking them into account when defining the universe of qualified loans.

For example, the bill would permit interest-only loans to qualify, even though such loans can adversely affect repayment ability at maturity due to the absence of any principal reductions. In addition, the bill would prohibit minimum loan term requirements (now set at 10 years), and it would extend the maximum allowable amortization schedule to 30 years (now set at 25 years). It would also bar the application of separate loan-to-value caps to account for the risk associated with appraisals that use lower capitalization rates than other loans. Yet each of these loan characteristics is associated with weaker underwriting and heightened risk.

In short, this bill would create a new exemption from the risk retention requirements for all single commercial real estate loans and groups of related loans. It would also water down the qualified loan exemption, broadening it to encompass loans of lower quality. These changes are likely to harm investors and increase the chances for the accumulation of systemic risk in the securitization market for commercial real estate loans.

H.R. 3868—Deregulation of Business Development Companies

H.R. 3868 would weaken multiple regulatory safeguards that govern the operation of BDCs. We have concerns, shared by the SEC, that the bill would expose investors to significantly greater risk, while diverting capital away from the companies they are intended to serve.

Congress established Business Development Companies in 1980 as a special type of closed-end investment company. Their principal mandate is to invest in small, growing, or financially troubled businesses, many of which cannot obtain credit through more mainstream banking channels. To help ensure that BDCs fulfill their underlying purpose, the Investment Company Act (ICA) requires BDCs to provide managerial assistance to its portfolio companies.

BDCs already present heightened levels of risk, due to the nature of their portfolio companies and the regulatory exemptions they enjoy under the ICA. For instance, BDCs are permitted to use more leverage than a traditional closed end fund, including a 1-to-1 debt-to equity ratio, as opposed to the more conservative 1-to-2 ratio applicable to other funds. And they can issue multiple classes of debt securities. However, even as it relaxed the regulatory requirements applicable to BDCs, Congress recognized that it was important "to avoid compromising needed protections for investors in the name of reducing regulatory burdens." [13]

The proposed bill changes the nature of BDCs by allowing them to increase their leverage; invest more money in financial companies rather than operating companies; and even purchase a registered investment adviser.

The Bill Would Double Permitted Leverage

The bill would allow BDCs to borrow more and double their already preferential leverage level. Because leverage magnifies potential losses as well as gains, this change would expose investors to a substantially increased risk of loss. Such losses would fall largely on retail investors, as they hold most BDC securities.

The current trends in BDCs cast further doubt on the wisdom of this approach. The BDC universe has expanded rapidly over the last 15 years, both in terms of the number of BDCs in operation and their total assets. From 2003 to 2015, for example, BDC net assets rose ten-fold, from $5 billion to over $52 billion. [14] On the other hand, reports have recently emerged that BDCs are becoming overleveraged even under existing regulations. [15] Adding a new layer of leverage risk under these circumstances would seem to be especially unwise.

BDCs Would Be Able To Divert Capital From Operating Companies to Financial Companies

H.R. 3868 would also allow BDCs to invest greater amounts in financial companies, thus diverting capital from the types of operating businesses they were intended to assist. Today, BDCs are required to invest 70 percent of their funds in small- or medium-size operating companies, referred to as "qualifying assets" or "eligible portfolio companies," which have often been rejected by ordinary funding institutions. Congress did allow BDCs to diversify their holdings by investing 30 percent of their funds in other securities, including financial firms. The 70 percent–30 percent asset holding structure of BDCs was selected after careful consideration and it was "chosen by the [Senate Banking Committee] as a matter of compromise between the [SEC] and the business development industry." [16] The 70 percent requirement was clearly intended to direct BDC investments toward the small businesses that actually produce goods and services.

This bill would expand the definition of "qualifying assets" to include other types of securities, including those issued by banks, brokers, insurance companies, and consumer finance companies, subject to a limit of 20 percent of total assets. With this new provision in place, BDCs could actually invest up to 50 percent of their assets in noneligible portfolio companies, including financial firms. Allowing such an increase in funding for financial firms would decrease the amount of funding directed to true operating companies by almost 30 percent. This approach conflicts with the basic rationale for the creation of BDCs: channeling capital to businesses in the real economy.

BDCs Would Be Able To Own a Registered Investment Adviser

Additionally, the bill would allow BDCs to own registered investment advisor firms. This too would divert capital away from the operating companies that BDCs were intended to serve. And it would enable a BDC, through control of its adviser, to circumvent various limits on BDC activities. For example, if the BDC's adviser were to manage a number of private funds, and invest BDC money in those funds, then it could exceed the BDC leverage limits as well as limits on a BDC's investment in financial companies. In addition, the adviser's clients would be exposed to conflicts of interest arising from the adviser's recommendation to invest in the parent BDC or its portfolio of companies.

In sum, these provisions in H.R. 3868 violate Congress's original admonition to avoid comprising necessary investor protections in the name of reducing regulatory burden.

Conclusion

Thank you again for the opportunity to appear at this hearing today. I look forward to your questions.

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[13] See H.R. Rep. No. 1341, 96th Cong., 2d Sess. 20-23 (1980).

[14] SEC Chair Mary Jo White, Letter to Representatives Hensarling and Waters, Nov. 2, 2015.

[15] Fitch: "BDC's Are Getting Overleveraged", *Barron's* (Apr. 25, 2016).

[16] S. Rept. No. 96-958, 96th Cong., 2d Sess. 23.

PREPARED STATEMENT OF DREW FUNG

MANAGING DIRECTOR AND HEAD OF DEBT INVESTMENT GROUP, CLARION PARTNERS, ON BEHALF OF THE COMMERCIAL REAL ESTATE FINANCE COUNCIL

MAY 19, 2016

Thank you Chairman Crapo and Ranking Member Warner for the opportunity to testify today. My name is Drew Fung. I am a Managing Director and Head of the Debt Investment Group at Clarion Partners. I am testifying today on behalf of the Commercial Real Estate Finance Council, or (CREFC), where I am a Member of the Executive Committee.

CREFC is the collective voice of the roughly $3 trillion commercial real estate finance market. CREFC's 300 member firms include balance sheet, Agency and Commercial Mortgage-Backed Securities (CMBS) lenders as well as loan and bond investors and servicing firms. Our industry plays a critical role in financing properties of all types in all 50 States including apartments, nursing homes, grocery, and retail, just to name a few.

My testimony will focus on the CMBS industry. In today's economy, CMBS is an essential financing vehicle for the U.S. economy. However, a plethora of new rules and regulations could dramatically affect CMBS liquidity, and thereby undermine the viability of this critical source of funding.

Introduction

The legislators and regulators had a daunting mission in restoring the health of the financial services sector following the financial crisis and the Great Recession. Eight years later, we have the benefit of empirical data and anecdotal experience about the very real costs of a macroeconomic crisis and also, the costs of regulation. Underpinning this data, it is now also a generally held view that deceleration in growth is likely to be a longer term feature of the national and global economies.

It is within the context of this growth picture that we must revisit our regulatory regime, and specifically its deleveraging objectives. It is critical to note that the Group of Twenty (G20) first added financial regulation to its agenda in 2009, broadening and enhancing the role that the international regulatory bodies played in determining home country requirements. At that time, goals for reducing leverage in the system were based on trends and observations ending with the deepest points of the mark-to-market losses. At the same time, there was little attention paid to the economic effects of regulation. It still remains a challenge to determine the collective effects and costs of the cumulative regulations aimed at the structured finance marketplace, partly because the rules are still being written, partly because some final rules have yet to take effect, and partly because they are so complex. Even so, many countries are seriously reconsidering the burden of the future regulatory agenda, given entrenched headwinds to growth. Some are not only contemplating, but also actively pursuing, relief for securitized products in order to support growth. [1]

More recently, the CMBS market has seen excessive and sustained dislocation, also referred to as "illiquidity". To a certain degree, geopolitical events are to blame for some of the distress that many markets experienced in February and March, yet these events do not account for all the distress. While other fixed income asset classes started to trade more normally in recent months, CMBS continued to exhibit numerous signs of relative distress. What accounts for this lagging effect on CMBS?

Market participants are unanimous in their belief that regulation is driving much of the present strategic decisions, and the effects of that regulation are causing the market to grow thinner and more fragile. Despite the fact most participants agree that credit trends in the commercial property market remain healthy, issuers and investors alike have shed staff, cut their budgets and reduced allocations. Some even closed their doors.

Weeks after researchers and other market watchers released their 2016 issuance forecasts (as high as $125 billion), many if not most, reissued forecasts at roughly half of their original numbers. Commercial Mortgage Alert published an estimate of $50–60 billion in their most recent issue (05/13/16). In other words, with little to no stress, and despite the fact that many other fixed income asset classes re-

[1] The below article discusses some of the measures being considered by the European Union: *http://www.wsj.com/articles/eu-proposes-new-capital-rules-to-boost-securitization-1443610493.*

gained their stride after the February pounding of oil prices and other macroeconomic challenges, the CMBS market continued to see record levels of volatility.[2]

While the regulators periodically revisit the deleveraging question in speeches and analyses, the U.S. regulators, in particular, seem unwilling to meaningfully investigate the role that regulation is playing in the fracturing of markets, fund flows, and the global slowdown. This frustration was felt by CREFC members while submitting comments during the agency rulemaking processes. There are countless instances in which our trade association and others provided well researched and documented analyses of the CMBS and other structured products markets. Yet, the regulators answer with rule requirements that are less tailored than they need to be for each asset-class, let alone CMBS, in order to maintain the organic efficiencies of the market in favor of simplifying the regulatory regime globally. Now that the CMBS market is exhibiting severe distress, and there is evidence of a negative feedback loop between poor liquidity conditions, lending rates and capital raising, the effects of regulation must be addressed, and done so quickly.

A strong contingent of CREFC's members believe that regulatory burden is responsible for reducing liquidity in and weakening the resilience of our market, despite the impact of geopolitical forces. Many believe that liquidity is the CMBS linchpin and that the regulations are causing permanent damage to it. Yet, even buy-and-hold investors, such as the pension fund universe (that is reportedly 6.99 percent invested in real estate)[3] need market liquidity in order to be able to meet their own regulatory and fiduciary requirements.

CREFC and its members believe that thoughtful regulation can be a net positive and that some of the new regulatory requirements have improved the marketplace and the alignment of interest between issuers and investors. While the broad intent of the regulations is well founded, the overwhelming burden of rules that lack tailoring to the characteristics of different asset classes provides little marginal prudential improvement, if at all. At the same time, these rules generate significant costs to the end users (i.e., borrowers and consumers) and to savers whose investments are devalued as a result. Consequently, there is a growing chorus of urgent concerns from all ends of the industry that regulation is institutionalizing inefficiencies and may even severely disable liquidity for the CMBS market permanently.

Moreover, lenders and investors agree that a dislocation in CMBS will travel quickly throughout the commercial real estate (CRE) debt and equity markets, impacting valuations and fundamentals. Certain aspects of the marketplace are so fragile today—even before half of the planned regulations come into place—that CMBS is experiencing severe pricing volatility, a marked contraction in issuance and reduction in capacity. We are working on borrowed time to investigate the solution and to initiate remediation, especially given the current schedule of new rules in the pipeline.

CMBS the Asset Class and Historical Performance

The securitization of commercial mortgages began out of the necessity to clean up the balance sheets of taxpayer-backed depository institutions in the late eighties and early nineties. A combination of excess development in the wake of strong commercial property demand, a subsequent economic downturn, tax reform, and loose credit from depository institutions led to a drastic overbuilding of office properties. By 1989, 534 depository institutions had become insolvent due to imprudent loans. Congress created the Resolution Trust Corporation (RTC) in 1989 to dispose of the failed institutions' assets. In turn, the RTC pooled the mortgages and sold them off as diversified bonds, creating the first CMBS transactions. Since then, the market has become much more transparent and investor centric.[4]

Credit retracted nationally across industries in the nineties. Not only had the universe of lenders shrunk dramatically, but the few banks that could lend on property were reluctant to do so, prompting innovative financiers to bypass the banking system for the capital markets. They pooled commercial loans and sold bonds tied to those loans to sophisticated institutional investors from pension funds and insur-

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[2] As measured by the standard deviation of swap spreads, which are the benchmark off of which CMBS are priced. Higher standard deviations indicate lack of liquidity. Current readings in CMBS suggest that the market is undergoing significant stress.

[3] According to a recent survey, U.S. institutional tax-exempt exposure to real estate debt and equity grew to $835 billion. One of the largest Asset Managers, TIAA-CREF, has $82 billion, or 9.4 percent, in exposure of a total of $866 billion in AUM as of 3/31/2015. *http://www.pionline.com/article/20141027/PRINT/310279999/real-estate-managers-back-over-1-trillion-again*

[4] Alan C. Garner, "Is Commercial Real Estate Reliving the 1980s and Early 1990s?" *https://www.kansascityfed.org/publicat/econrev/pdf/3q08garner.pdf* (2008).

ance companies. By 1998, issuance topped $50 billion per year, and by 2007, issuance topped $200 billion per year.[5]

One of the attractive features of CMBS was that institutional investors (entities with monthly, quarterly or actuarially driven cash flow obligations) could achieve greater diversification across geography and asset class than by purchasing or originating whole loans themselves. Instead of owning a $50 million loan on a single property, the investor could purchase $50 million worth of bonds equally diversified on a pro rata basis across 40–100 loans in 10–30 individual markets. And importantly, the investor could decide how much risk they wanted to take based on a bond's seniority in the capital structure and the duration of the security. The most secure bonds received cash flow payments first, while the riskiest bonds last. In the event of a distressed sale, bond holders are paid before the borrower who contributed the equity. Typically, these securities offer more yield, transparency, and diversification than similarly rated corporate bonds.

At the asset level, an investor, generally a business entity (a partnership or corporation), seeks to purchase a commercial property and obtain debt financing for that transaction. Each commercial property can be thought of as a self-contained business with an income statement and balance sheet. The rents charged to use a property—including monthly apartment, office, or retail rents—serve as the "sales" or revenue for the business.

Similarly, a property has expenses in the form of third-party property management fees (landscaping, maintenance, etc.), property taxes, insurance, leasing expenses (as in the case of an apartment leasing manager, or a retail leasing agent, who go and find renters for the property), and noncapitalized annual repairs to the property. These expenses subtracted from total revenues represent the property's profit and loss, or "P&L". It is through this number that all applicable underwriting calculations, such as debt service coverage ratio (DSCR), whether from the investor or lender, are calculated.

The property owner's ability to pay off debt is not measured (since all CMBS loans are nonrecourse), but rather, the property's, or business's ability to service monthly payments is measured. A mid- to long-term holder of commercial property, regardless of property type, buys a building based on how much cash flow, or yield, the asset will generate each year, and considers hundreds of data points (ongoing surveillance of CMBS is reported on a monthly basis via the CREFC Investor Reporting Package (the "IRP"), a monthly report with over 750 data fields and supplemental reports providing insight into asset, loan, and bond level performance, as well as the final disposition of specially serviced CMBS loans,[6] in addition to a business plan that includes market information ranging from demographics, supply and demand factors for the asset type, and relative positioning to comparable products.

Post-financial-crisis (also known as "CMBS 2.0"), there are two distinct CMBS markets: the conduit market and the single-asset single-borrower (SASB) market. The conduit market pools commercial mortgages ranging in size from $2 million to over $100 million (but generally not more than $100 to $300 million). These loans are collateralized by stabilized, cash-flowing properties with three years of operating history and professional ownership. As thousands of small banks either closed their doors or were purchased by larger firms in the wake of the 2008 credit crisis, conduits remain a substantial source of debt for secondary and tertiary market real estate operators. Conduit financing provides capital for grocery store shopping centers, strip malls, family owned hotels, shopping malls, and apartment buildings.

The other type of CMBS lending is SASB loans. These loans typically are larger than $250 million and are made on a single, large property or portfolio of properties owned by one borrower such as large, well-capitalized, public and private real estate companies. Last year, SASB made up over one-third of the total CMBS market, up from roughly 10 percent historically.

Institutional investors enthusiastically invest in SASB bonds. The demand for this market came about as banks and insurance companies were unable or unwilling to offer their balance sheets to finance trophy buildings or portfolios of properties. The credit characteristics of these loans are highly desirable—often many times oversubscribed by investors. Due to the durable nature of CRE's cash flow, and subsequently the CMBS bonds, the asset class as a whole has performed extremely well.

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[5] Sam Chandan, "The Past, Present, and Future of CMBS", *http://realestate.wharton.upenn.edu/research/papers/full/730.pdf* (2012).

[6] For information on the IRP, please visit: *http://www.crefc.org/irp* or see Appendix A. This information anticipated by almost 20 years asset-level information now required by the SEC for other asset classes.

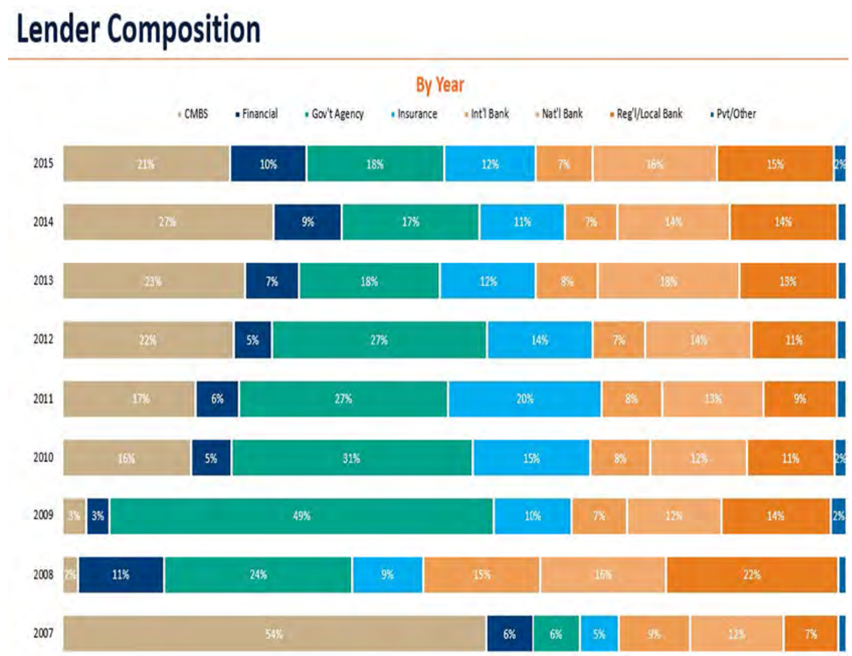
The all-time cumulative loss rate for SASB transactions is 0.25 percent, and 2.79 percent for conduit transactions.[7]

SASB transactions performed better in the depths of the crisis than most fixed income markets perform under efficient market conditions. Due to the structure and transparency of SASB deals, investors were (and still are) able to make informed decisions. With performance characteristics such as these, it is fairly improbable that regulation could benefit the market. Indeed, when members of the regulatory community have been asked this question, often the answer is that it is difficult for the agencies to grant exceptions. CREFC discussed these issues at length with the Agencies responsible for crafting the risk retention, and our list of submissions to the regulators can be found in Appendix B.[8]

Why CMBS: Borrower Access to Credit

CMBS provides the most democratic and cost effective method of financing for small real estate assets. While SASB financing makes it possible to spread the risk of a large dollar loan on a single property, conduit financing is an essential component of the main-street CRE market. If traditional credit providers—banks and life companies—service the borrowers who need mid-sized loans, then CMBS serves the ends of the barbell, with SASB transactions that are too big for a single institution to handle on one end, and loans on small, privately owned real estate companies and syndicates that make up 90 percent of CRE ownership on the other.

In 2015, CMBS provided 21 percent of all of all CRE loans. This is the sector's largest financing source, followed only by agency debt (18 percent) and regional banks (16 percent). Annual originations by banks and life companies ebb and flow, but have generally been steady and limited to specific niches. While CMBS's 50 percent market share in 2007 was arguably too high, as witnessed prior to the crisis, securitization has proven to pick up a large portion of the slack that portfolio lenders and the Agencies typically eschew.



One of the most popular sentiments expressed by all types of CREFC members (buy- and sell-side) is that the broader CRE market needs CMBS in order to function efficiently and to fill the gap in financing needs posed by underserved bor-

[7] As of 08/31/2013, per CREFC's comment letter to regulators.

[8] See CREFC's Letter to various regulators on Risk Retention: *http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf.*

rowers in smaller cities and suburban areas. For instance, Idaho currently has over $1.1 billion worth outstanding loans distributed across cities including Boise, Twin Falls, and Meridian. Similarly, Virginia and Massachusetts currently have over $26 billion and $17 billion, respectively, in outstanding CMBS financing (please see Appendix G for a breakdown of each State's outstanding CMBS loans).

The CMBS market represents a core source of capital that cannot easily be replaced. When new issuance is halved in a single year, especially one in which there are significant refinance needs, it is realistic to expect a broader market disruption. During liquidity interviews, CREFC members had significant concerns over the impact a declining new issuance market would have on bond values, and more importantly, property values. Members noted that all things being equal, removing 20 percent of available debt capital from the marketplace would surely depress property values. Members also noted that they did not see a ready alternative to CMBS financing—that is, long-term, fixed rate mortgages. Instead, bank participation will be declining as the regulatory regime is ramped up across all banks, big and small, and as the regulators enforce limits on CRE exposures.

Maintaining availability of CMBS financing is even more critical following regulatory warnings regarding CRE concentrations at banks. Many bank lenders in our membership report intentions to maintain, instead of grow, loan levels, which means that any reduction in the CMBS market should represent a reduction in capital availability across the sector. While some 1Q 2016 data series indicated that loan levels are still growing, the spurt in the first quarter represents loans that were negotiated before the end of the year and the prudential agencies published a warning to the CRE lenders.[9] Indeed, the April 2016 Senior Loan Officer's Opinion Survey reflected a tightening of underwriting standards across the industry for the first time in this cycle, FRB: Senior Loan Officer Opinion Survey on Bank Lending Practices and this is considered to be a leading indicator of future trends. Industry watchers report that the CRE loan pipeline has contracted in 2Q 2016, which should be reflected in the second half of the year.

Evolution of the CMBS Market Before and After the Crisis

The CMBS market is generally viewed in two historical segments—CMBS 1.0, which existed before the crisis, and CMBS 2.0, which commenced after the crisis. The reason that the two phases are delineated is that the CMBS market has greatly evolved in several critical ways since the crisis: (1) pro forma (aspirational) underwriting is infrequently mentioned and in fact, underwriting criteria have been tightening;[10] (2) CMBS deals include much greater levels of subordination, or cushion, to absorb potential losses (see exhibit below); (3) collateralized debt obligations (CDOs) backed by CMBS are no longer issued; and, (4) even greater transparency and information is provided to investors.

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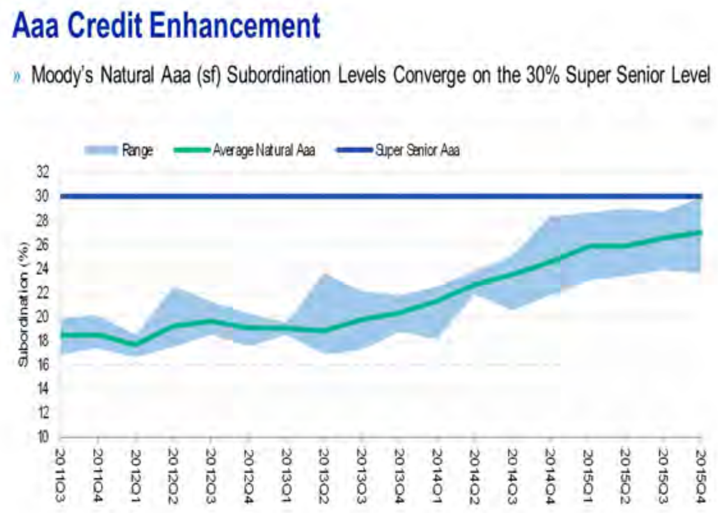
[9] *https://www.federalreserve.gov/bankinforeg/srletters/sr1517.htm*
[10] *http://www.federalreserve.gov/boarddocs/snloansurvey/201605/*



Source: Moody's Investors Services

Recent economic conditions were primed to result in a return of aggressive lending and funding. Environments marked by low rates and improving credit trends, as we saw in recent years, are prime ecosystems for higher leverage, because the economics work. However, risky leverage did not return to the CMBS market. In fact, the opposite happened. The levels of loan and deal level leverage remained much lower than in CMBS issued prior to the crisis (CMBS 1.0). Importantly, the double leverage that came with CDO funding seems to be wrung out of the system.

Early regulatory and industry intervention at the beginning of the crisis were indeed the integral in weeding out the most ambitious lending and financing forms from the CMBS industry. The combination of accounting changes and additional requirements of the rating agencies, as well as other rules helped to stabilize the CMBS market starting in 2010. While the Term Asset Backed Loan Facility (TALF) did support several CMBS transactions, the TALF's activities in the commercial market were limited. In other words, the market participants agreed on a new architecture which instilled the requisite confidence from both buy and sell sides. This caused the market to rebound with little assistance from the TALF facility established to liquefy the market during the crisis.

Indeed, CREFC members played a vital role in this stabilization, as our community contributed a critical new feature of the CMBS 2.0 (postcrisis CMBS) marketplace—additional transparency measures in the form of the IRP, described in detail above, and in Annex A, which is the deal package. (See Appendix A for more details on CREFC IRP). These two transparency measures are proof that through the leadership of CREFC, the CMBS industry has self-regulated over the years as investors demanded standardized deal documents and up-to-date performance data.[11] However, regulators gave the industry little credit for these self-imposed reforms.

In 2009, CMBS issuance had collapsed to almost $0 from a height of $231 billion in 2007. Issuance rebounded to roughly $100 billion in the private label market last year. Until recently, many bonds had excess bidders and the CMBS market enjoyed inflows of capital correspondent with performance. It seemed that despite low inter-

[11] A full list of these self-regulatory measures is available in CREFC's letter to the Federal Reserve System, the FDIC, Treasury, the SEC, and the OCC: *http://docs.crefc.org/uploadedFiles/CMSA_Site_Home/Government_Relations/Financial_Reform/Risk_Retention/Risk%20Retention%20Proposed%20Rule%20Comment%20Letter.pdf.*

est rates, market participants generally agreed that CMBS was functioning well in the main.

As a result, CMBS 2.0 has continued to evolve. First, more stringent accounting and rating agency rules resulted in greatly reduced economic incentives for CDO structuring. Now that CMBS are not releveraged through CDOs, the dollar value of investable capital is lower today than it was when interest rates were higher. Second, the rating agencies have all significantly revised their models and required much greater amounts of subordination. As a result, the bonds at the bottom of the stack that absorb losses have roughly doubled. Third, better transparency in the form of Annex A and the IRP, now in its 8th version, has reinforced better underwriting standards and more extensive due diligence. While the market is constantly evolving, CREFC believes that these positive conditions are not temporary, but rather more permanent features of the CMBS 2.0 market and the upcoming CMBS 3.0 market.

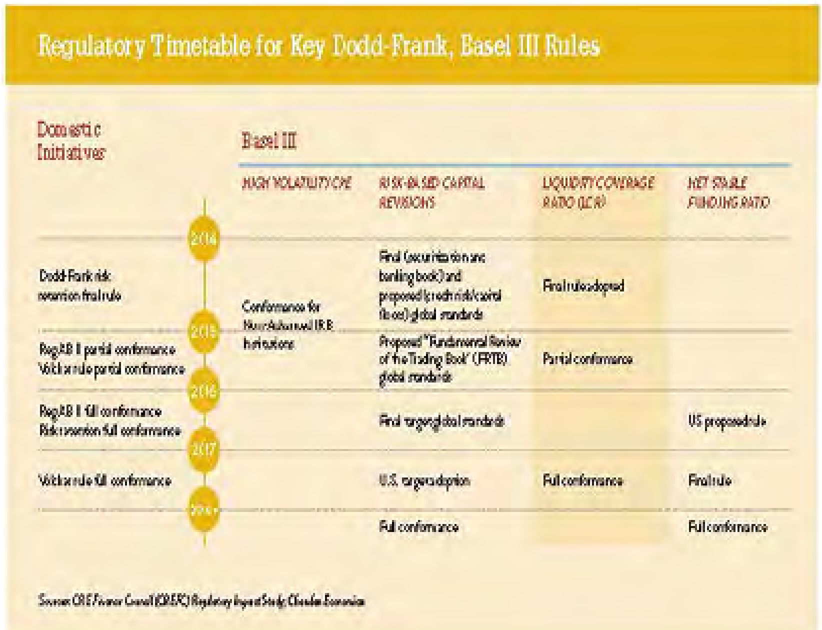
Regulatory Regime and the Question of Effectiveness

The CREFC community is generally supportive of prudent regulation that appropriately weighs the cost of the requirements with the corresponding benefit it is expected to achieve. In our comments to the various regulators, including the Securities and Exchange Commission (SEC), we made this fact known and expressed a desire to work with them in identifying solutions that would enhance positive market practices, including those put in place by the CMBS market itself. Currently, the CMBS market is subject to an extraordinary amount of direct regulation, and many of these measures have the impact of treating CMBS more harshly than other asset classes (e.g., Fundamental Review of the Trading Book and Liquidity Coverage Ratio). Further, there are innumerable rules that indirectly impact the market by greatly changing the conditions under which the entire financial system operates. These rules then drive the conditions in which CMBS functions. Of the subset of these new rules that affect CMBS most directly, there are:

- the accounting changes FAS 166 / FAS 167;
- rating agency rules;
- Regulation AB II (a set of disclosure requirements);
- reporting requirements to the TRACE facility;
- Volcker Rule (which sanctions CMBS market making but presents a set of very high hurdles for compliance);
- Basel III leverage ratio (which affects how market making desks fund themselves with repurchase agreements);
- Liquidity Coverage Ratio (LCR);
- Net Stable Funding Ratio;
- Risk based capital rules; and
- Risk Retention rule (which requires that issuers hold 5 percent of a securitization).

Last year, CREFC produced a study [12] of the regulatory impacts on the CRE sector overall and found through interviews and quantitative analysis that taken together, regulation has done some good things for our sector, but it has also reconfigured the structure of the markets in such a way that makes it ultimately less resilient in times of stress. These outcomes generally run counter to broader policy goals of maintaining sound functioning markets and supporting sustainable growth. Broadly speaking, the rules under the Dodd-Frank Act and also the various components of Basel III discriminate against longer-term assets and those that are not highly standardized, such as residential mortgages. At the same time, there is little acknowledgment of the unique transparency in the CMBS market or how the market functions differently than other asset classes that tend to be traded on more of a quantitative, and less on a fundamental, basis.

[12] *http://www.crefc.org/CREFC/Publications/Regulatory__Impact__Study/CREFC/Resources/Regulatory__Impact__Study.aspx?hkey=47af34d5-3cea-43e1-942f-309fd7508928*



CMBS Liquidity and Market Resiliency

The universal concern of all industry participants is that the constant march of new regulatory requirements will create such a drag on margins that a critical mass of participants will exit. Many CREFC members have commented on this likely end game for CMBS now that they can envision a more complete regulatory timeline.

Starting with the risk retention rule, which goes into effect on December 24, 2016, borrowers, issuers, and investors are keenly analyzing implementation at this time. CREFC gathered estimates last year and found that the regulation would likely add roughly 10 percent to the interest rate the borrower pays. This number was calculated assuming stable conditions and before CMBS participants started to consider the implementation challenges in earnest. Based on a sampling of issuers and investors more recently, CREFC found that on average, our members believe that much of the current spread widening is driven by regulatory burden, suggesting that the 10 percent of marginal costs originally estimated will prove to be lower than the actual costs incurred in a volatile trading environment such as the one prevailing for some time now. Given that risk retention is the next piece of regulation to move into effect for our sector, it can reasonably be credited as the greatest driver of costs to the borrower at this time and one of our industry's top priorities. The regulatory factor is often cited as the driving force beyond continued spread volatility at this time, while other fixed income asset classes revert back to more stable trading environments.

CREFC and the majority of its members have often supported differentiated treatment for SASB bonds, because the asset class has performed better than most other fixed income sectors, and in some ways, is simply the best performing sector through the crisis. Yet, the six regulators that were obligated to promulgate the risk retention rule, chose to include SASB deals in the coverage universe, even though there was very little, if anything, more that rules and restrictions could accomplish with the sector.[13] The risk retention rule was written with conduit structures in mind, yet will also be applied to the SASB universe, despite the fact that the requirements cannot be adopted without wholesale restructuring the SASB model and the market with it.

[13] With an historical realized loss of 0.25 percent, SASB deals have performed remarkably well, which explains the spike in investors' demand for these bonds in recent quarters.

Additionally, it is important to note that risk based capital rules and the LCR are steep for our sector, and, more importantly, they treat CMBS relatively poorly compared to other financial instruments. Additional rounds of Basel capital requirements will make CMBS even less viable. Based on a series of interviews conducted with market leaders since the beginning of 2016, the FRTB, which changes capital requirements for all inventories kept for market making purposes, has been cited as one of the most concerning pieces of regulation, if not the most.[14]

Even though the Basel Committee on Banking Supervision (BCBS), reduced the magnitude of the charges applied to CMBS in the final version of the FRTB published on January 14, of this year, these requirements place CRE-backed deals on par with subprime residential mortgages. In turn, it will be even more challenging to allocate capital to CMBS businesses, and ensures increased fragilities. The LCR, which is the first of two new liquidity requirements under Basel III, is also an example of a punitive approach toward all nonsovereign asset classes, but particularly, securitizations and CMBS. The LCR requires that CMBS issuers apply an additional cost to the production of their assets, even after they have been sold. The recently proposed Net Stable Funding Ratio follows the LCR's construction and is expected to additionally disadvantage CMBS relative to other asset classes.

Other Countries Easing Regulatory Treatment of Securitizations

In contrast to the tightening of the regulatory regime in the U.S. anticipated in the near future, the European Union is using the securitization markets to help restart growth. Policy makers across many jurisdictions and throughout legislative and banking authorities have recognized in many ways that the securitization markets can provide safe and alternative funding to the banking system. As such, the European Central Bank (ECB) is utilizing the financial technology as part of its small- and medium-sized business program.

Additionally, the ECB and other European regulators have begun to consider how to ease the burden on safer securitizations through reduction of risk based capital requirements and other mitigating measures. Importantly, they have noted that compliance and accounting measures have increased the discipline in the markets and believe that an offset in the capital and liquidity requirements would be warranted.

The European authorities are not the only jurisdictions contemplating a reduction in the regulatory burden on structured products. In light of slowing growth globally, other regulatory agencies have considered certain changes too, including China, Japan, and Australia.

Regulation and Market Liquidity

In short, these regulations are and will continue to have a significant impact on CMBS. The precipitous decline in CMBS liquidity (e.g., inventories, turnover, trade size), especially the prolonged spikes in swap spreads, are particularly troubling. These trends suggest that the market is trading inefficiently; in the absence of credit concerns, anticipation of the next round of regulation must be driving much of the volatility. Moreover, certain trends suggest that the pattern may be sustained for some time, if not deepened becoming a negative feedback loop as many have warned:

a. The number of market making platforms is declining rapidly, especially those that provide "balance sheet" and that can hold inventories. Based on a partial survey of the market in April, it appears that at least one in five people have been downsized this year, and at least one institution, the number is reversed; of five original market-making staff, one remains. One member investor speculated that there were 10 true dealers with capacity to hold inventories and to make markets across a range of new issues last year; that number was halved by year-end 2015 and as of this writing, the number is now down to two or three true market makers.

b. As expected, the investors who relied on liquidity—those who care more about total returns than relative value—have exited en masse in lock step with the liquidity providers, leaving a distinct and troublesome gap at the lower end of the bond stack.

c. Yet, buy-and-hold investors have reacted decisively to the distress in the market too by reducing allocations to the sector and many are actively retreating

[14] Even after the Basel Committee on Banking Supervision reduced the risk weighted requirements for structured products in their final version of the standards published on January 14, 2016, industry participants anticipate that new U.S. rules may require that market makers maintain more capital than the market value of certain CMBS bonds.

from the conduit market. All are concerned about the ability to price their investments accurately in a volatile market.

d. The proportion that CMBS represents in the Barclays Aggregate Index, which is the one of most often used fixed income benchmark indices, has declined significantly to 1.2 percent from a high of 5.7 percent, meaning that the demand for CMBS will continue to decline.

e. While there were roughly 40 conduit lenders and sellers last year, they too are closing their doors and now number roughly 28.

f. The pipeline of new issues has been moving at a slow pace since April. The SASB deal calendar, especially, seems to be drying up in the summer with a couple of small deals scheduled in June and none in July.[15] Both sides of the business are seeing smaller deal sizes, which also indicates general lack of liquidity and is a concern for both buyers and sellers.

g. The primary hedging instrument for the industry, the CMBX, has begun to trade very differently than the underlying cash bonds, which also indicates inefficiencies in the market and portends a deepening of the dislocation if pricing of the two products, the bond and the hedging instrument, do not become reasonably more correlated in their movements again.

Demand for liquidity relative to market supply is stark. A survey of issuers, traders, investors and other market participants conducted by CREFC in early February suggests that, market-making capacity was already undercapitalized by one quarter to one half. Since then, additional traders have lost their seats, draining further capacity from the system.

Recommendations and Conclusions

Considering all of the perverse impacts of regulations—both individually and in the aggregate—our list of recommendations would be long, and mostly within the regulatory purview. As such, we began this process first by petitioning the regulatory community for correction and clarification. Regulators accepted some of our recommendations but also declined a good number. It is for this reason that we now seek Congressional intervention.

From the legislative perspective, we urge the Members of this Committee to work together in a bipartisan fashion to introduce the companion to the bill sponsored by Representative French Hill of Arkansas. H.R. 4620, the "Preserving Access to CRE Capital Act" addresses the challenges posed by the risk retention rule in a targeted, fair, and responsible fashion. Though the recommendations in the bill do not affect the core requirements codified in the Dodd-Frank Act, Section 941,[16] they are meaningful and would have a positive impact on the marketplace. The majority of CREFC issuers, investors and servicers support the bill, however, there is a minority contingent of investors who support the final regulation without modification.

Introduce and Report Out of Committee a Companion to H.R. 4620

CREFC strongly supports the recommendations below, which restore the proper balance between protective measures and a healthy, functioning CMBS market for the borrowers and employers in every Congressional district. Specifically, the recommendations would: (1) exempt from the risk retention requirements the highly sought and extraordinarily transparent SASB transactions; (2) set reasonable parameters for regulating and designating as "qualified" certain high-quality commercial loans (QCRE Loans) under the risk retention rules; and (3) provide flexibility in structuring the retained interest to suit investors without modifying the amount nor relaxing the general restrictions surrounding the retained interests.

First, the recommendations would address the issues related to the transparent and high-performing SASB transactions by making them exempt from the risk retention requirements. As mentioned above, SASB transactions are marked by superior performance—the SASB segment booked a mere 0.25 basis points in cumulative losses between 1997 and 2013. This financing option is ideal for borrowers seeking to finance apartment complexes, hotels, office buildings, and, of course, gateway market "trophy" properties. Despite this superior performance, current regulations do not include an exemption for SASB transactions, which threaten to raise borrowing costs, decrease borrower choice in this market, and induce them to seek other modes of financing that may be less transparent and low risk (e.g., corporate bond markets).

[15] Commercial Mortgage Alert, 05/13/16.

[16] Issuers/sponsors must retain 5 percent of the credit value of the bonds for 5 years, during which time the bonds cannot be hedged (except for interest rate and foreign exchange).

Second, the recommendations would put in place commonsense parameters for considering which CRE loans would be deemed "qualified" under the risk retention requirements. Currently, only a small percentage of CMBS loans would be considered as QCRE loans, and exempt from the risk retention requirements. Although modeled after the Qualified Residential Mortgage (QRM) exception, the application of QCRE has vastly different consequences. Surprisingly, private label residential mortgage-backed securities were given a generous set of qualifying requirements under the QRM standard; in fact, it is estimated that nearly all of today's RMBS loans would qualify for an exemption. Yet, conversely, in the CMBS space, the qualifying conditions are so onerous that only 3 percent–8 percent of all CMBS conduit loans written since 1997 would qualify for an exemption from the core 5 percent risk retention requirement. This has little sense of proportion or compelling rationale.

H.R. 4620 would moderately widen the underwriting requirements for QCRE, thus helping maintain credit quality in this space, along with stable pricing and availability of financing for a broad swath of business owners. Specifically, the bill would allow pools of unrelated/unaffiliated, or conduit loans will be allowed to amortize over not more than 30 years (from the current 25-year standard); permit low-LTV interest-only loans to be treated as "qualified" where no authority was granted previously; and permit loans less than 10 years in term as qualifying for exemption under the QCRE rule. We expect that this would raise the QCRE percentage to about 15 percent of all loans, still well below all the RMBS loans that will qualify under the QRM exception. In other words, the parameters are targeted and responsible. In no way would it allow a blanket carve out for the CMBS community, rather it would only truly apply to transparent and highly performing loans.

Third, under the risk retention rules, there are special rules for CMBS that allow a third-party investor to purchase the B-piece (known under the rule as the eligible horizontal residual interest, or "EHRI"). The risk retention rule allows up to two third-party investors to share the 5 percent retention burden, but requires them to hold their positions pari passu (i.e., horizontally). The proposed legislation supported by CREFC would allow third-party purchasers to share the retention obligation pari passu or in a senior-subordinate (i.e., vertical) structure. H.R. 4620 does nothing at all to change the core retention requirement or any of the other requirements surrounding the B-piece investors. The core 5 percent retention requirement and all other general requirements (e.g., substantive due diligence, holding the interest for 5 years, etc.) would remain intact.

The legislation allows for a reasonable amount of flexibility in how the B-piece is held internally by two purchasers. This flexibility will allow the B-piece buyer to match investor capital with the additional capital investment (the retained risk amount) that the rules require. For CMBS, the required amount of risk retained will be about two times that of what is currently invested by B-piece buyers in a typical CMBS deal. That is a massive amount of incremental capital B-piece buyers have to raise in order to be risk retention compliant. And that investment is essentially nontransferable—meaning that the funds raised will be "parked" in a single deal for at least 5 year. Obviously, this comes with an illiquidity premium that investors will seek—further increasing costs to borrowers. The senior-sub structure will be used to help align investors with this new retained risk requirement. It will not affect at all the amount of risk that must be retained, the underwriting due diligence required by the rules or the holding period requirements of the rules. It simply gives the industry flexibility to achieve the risk retention goals of the regulations and is supported by 14 real estate trade associations. [17]

Conclusion

CREFC would like to thank the Members of this Subcommittee for providing us the opportunity to submit this statement. CREFC asks that the Subcommittee give serious consideration to the negative consequences of the latest round of rulemaking—consequences far beyond the CMBS markets. More to the point: without a robust and competitive CMBS marketplace our members anticipate a liquidity-driven stress event that could potentially take years to rebalance as market participants leave the arena for other lines of business. This imbalance will have far-reaching and profound effects on communities in a very visible way, by constricting the funding for commercial properties that we all come to rely on daily for our groceries, housing, workplaces, health care, education, and goods and services. In short, the roughly $200 billion of maturing CMBS debt in the next 2 years will need to be financed regardless of the actions Congress takes. In the absence of intervention and continuity of a competitive CMBS marketplace, we fear that buildings currently

[17] See Appendix B for Industry Support Letter to House Financial Services Committee

funded could fall into foreclosure, resulting in blighted, perhaps empty structures and loss of principal for America's pension and other investors and retirees.

We remain optimistic that there is time to correct this looming liquidity crunch, and we are eager to work with Members of the Committee, and with Congress, to ensure that the discretely tailored recommendations become law.

Appendix A: CRE Finance Council Investor Reporting Package

The key items of interest included in the CRE Finance Council Investor Reporting Package (IRP) include the following data and supplemental reports that are filed monthly or on an as needed basis.

- Master Servicer Files
  - Loan Setup
  - Loan Periodic Update
  - Property Files
  - Financial Files
- Property Income Statements (Borrowers and Property)
- Special Servicer Loan File
- Special Servicer Property File
- Schedule AL File (Required by SEC)
- Trustee Data Files
  - Bond Level Summary
  - Collateral Summary
- Supplemental Data Reports to be filled out by Servicers
  - Servicer Watchlist/Portfolio Review Guidelines
  - Delinquent Loan Status Report
  - REO Status Report
  - Comparative Financial Status Report
  - Historical Loan Modification/Forbearance and Corrected Mortgage Loan Report
  - Loan Level Reserve/LOC Report
  - Total Loan Report
  - Advance Recovery Report
- Supplemental information to be supplied by Servicers:
  - Appraisal Reductions
  - Servicer Realized Losses
  - Reconciliation of Funds
  - Historical Liquidation Losses
  - Interest Shortfall Reconciliations
  - Significant Insurance Event Report
  - Loan Modifications
  - Loan Liquidations
  - REO Liquidations
  - 1099 A/C Tax Forms for Servicers

Appendix B: Industry Support Letter for H.R. 4620

February 29, 2016

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

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

Re: H.R. 4620 to Amend the Securities Exchange Act of 1934 to Modify Requirements for Qualified Commercial Real Estate

Dear Chairman Hensarling and Ranking Member Waters:

The undersigned organizations express strong support of H.R 4620, the "Preserving Access to CRE Capital Act," a bill that makes minor, but important, modifications to credit risk retention rules for commercial real estate loans. The credit risk retention rules are a product of six federal agencies and cover all securitized assets and were intended to incentivize better underwriting. Despite best efforts by the regulators to write one set of rules encompassing all differing securitized asset types, the rule in its current form, will not achieve the objective, especially when operationalized at the same time as so many other new requirements that are also targeting securitizations. H.R. 4620 makes minor modifications to the rule, while maintaining the core components of the risk retention, to ensure continued liquidity and affordable financing options for commercial real estate borrowers in every Congressional district.

Specifically, the Preserving Access to CRE Capital Act would allow very prudently underwritten, low-risk commercial real estate mortgages to meet the criteria for qualified commercial real estate ("QCRE") loans under the risk retention rules. The revisions, in fact, were based on performance and correlate to those loan characteristics that performed the best from 1997-2013. As "qualified" loans, they would not be subject to risk retention and the associated punitive costs associated with it. The bill also provides relief for prudently underwritten, single asset-single borrower loans. Barring some form of relief, many smaller commercial markets across the country will not be able to finance projects that could spur development and create jobs in the areas that need it most.

In contrast, the same rule exempted over 90% of residential loans being made in this country currently. Whereas for commercial loans, it grants only 3-8% of all loans the same "qualified" treatment, which is too small a target to influence underwriting trends. As one of the largest sources of credit for commercial and multifamily real estate in the United States, the commercial mortgage backed securities (CMBS) market is an important element of the over $3 trillion commercial real estate debt market, currently comprising roughly 26 percent of the overall market. In secondary and tertiary markets, the percentage of liquidity is even greater. Chances are, you know a borrower by name and an address by heart in your district that utilizes this type of capital.

CMBS provides financing to retail, office, apartments, industrial, health care and many other types of commercial real estate. If the rule is not modified before going into effect at year-end, a large percentage of borrowers across the country will not be able to refinance their loans without additional capital and higher monthly costs. Following the stress this will cause elsewhere in the system, valuations will be hurt and savers' investments will suffer as a result of the reduced liquidity in the system.

This bill remedies an oversight by regulators that would impair, for no discernable safety and soundness reason, the availability of capital to commercial real estate borrowers and therefore increase borrowing costs. Recently, CMBS has led the market by providing roughly 45% of lending for America's tertiary markets and nearly 30% for secondary markets.

We strongly urge committee passage on HR 4620.

Sincerely,

Commercial Real Estate Finance Council (CREFC)

cc: Members of the Committee

Appendix C: CREFC and Industry Background Industry-led Reforms

Since the crisis, CMBS market participants have sought to address industry weaknesses. A broad variety of stakeholders have taken steps to promote greater levels of discipline in loan origination, structuring, monitoring, and disclosure.

As part of its core mission, CRE Finance Council works closely with its members, including the majority of CMBS issuers, B-piece buyers and servicers, as well as leading investors in the asset class, to establish best practices. In response to the crisis, CRE Finance Council members developed and enhanced several sets of documentation and practice standards, which materially add to market transparency, standardization and efficiency.

The below templates and standards were developed by working groups under the auspices of the CRE Finance Council and staffed by volunteers from the CRE lending, investing and servicing communities. These resources are reviewed and refreshed ongoing, so as to remain relevant and meaningful.

1. ***CREFC Investor Reporting Package (U.S. and EU Versions):*** Standardized and comprehensive package of bond, loan and property level information used extensively in the CMBS marketplace. This data is collected prior to issuance and throughout the life of the transaction.
    a. ***CREFC Special Servicing Disclosure Reports* added to *IRP™:*** New disclosure reports adopted December 2012 providing increased transparency surrounding special servicer activities, including information regarding affiliates, fees, loan modification decisions, and the final disposition of specially-serviced CMBS loans.
    b. ***Standardized Annex A:*** Provides a deep data dive on the largest loans within the transaction, including enhanced granularity regarding operating statements and additional data with respect to escrow accounts and reserves.
2. ***Pooling and Servicing Agreement (PSA):*** First offered to the public by CREFC's predecessor, Commercial Mortgage Securities Association. Since the crisis, numerous enhancements and modifications have been made, including more specific deal terms and conflict resolution standards for issues involving servicers.
3. ***Model Representations & Warranties:*** Standardized set of representations and warranties for inclusion in transaction documentation regarding the accuracy of loans in the pool, including more than 50 parameters. This is a critical feature of CMBS documentation as it enables investors to pursue loan repurchases in the event of material breaches; representations and warranties essentially function as a loan-level form of "skin-in-the-game" for the originators, issuers and sponsors.
4. ***Principles-Based CRE Loan Underwriting Framework:*** Set of principles establishing industry best practices in underwriting processes and characteristics, encouraging standardization and lower risk-taking in lending.

Appendix D: Links to CREFC Comment Letters and Submissions

Risk Retention

- June 19, 2014: Follow-up to Meeting at the Board of Governors of the Federal Reserve System
- February 28, 2014: Submission to the Agencies regarding risk retention and treatment of SASB & QCRE
- October 30, 2013: Joint Trade Association comment letter regarding the risk retention proposed rule
- October 30, 2013: CREFC comment letter regarding the risk retention proposed rule
- July 18, 2011: CREFC comment letter regarding the original risk retention proposed rule

Reg AB II

- March 28, 2014: CREFC comment letter regarding asset-backed securities
- October 4, 2011: CREFC comment letter regarding asset-backed securities
- August 2, 2010: CREFC comment letter regarding asset-backed securities

Basel Capital Requirements

- March 27, 2015: Joint trades comment letter regarding capital floors
- August 12, 2014: Joint trades comment letter regarding treatment of securirization
- July 25, 2014: CREFC response to BCBS – IOSCO survey on treatment of securitization
- March 24, 2014: Joint trades comment letter on securitization framework

Basel Liquidity Requirements

- March 13, 2014: CREFC comment letter regarding the liquidity coverage ratio

Volcker Rule

- February 13, 2012: CREFC comment letter regarding the Volcker Rule

Appendix E: Timetable for Regulatory Implementation

Rule	Impacted Sector	Concern	Effect	Secondary Effect	Regulator	Status	Fully Effective
Supplementary Leverage Ratio (SLR)	Banks	Risk weightings do not fully capture the risk of a bank	Banks less leveraged	Higher prices/spreads for repo	Fed, FDIC, OCC	Final rule released	January 1, 2018
Liquidity Coverage Ratio (LCR) / High Quality Liquid Assets (HQLA)	Banks, Shadow banking	Banks during the financial crisis did not have enough liquid assets to weather prolonged periods of stress	More difficult for banks to hold non-liquid assets	Higher spreads/less liquidity for RMBS, CMBS	Fed, FDIC, OCC	Final rule released	January 1, 2017
Net Stable Funding Ratio	Banks, Shadow banking	Mismatch between duration of assets and liabilities	Banks punished for liquidity mismatch	Reduction in repo funding	Fed	Not yet proposed	January, 2018 (est.)
CCAR	Banks	Banks and regulators did not have a prospective look at impact of adverse economic scenarios/banks overly aggressive with capital management	Conservative capital management; trapped capital	Reduced lending to marginal credits	Fed	Rule in force	March, 2011
Living Wills	Banks, Nonbank SIFIs	No orderly way to unwind large, interconnected firms	Firms required to plan liquidation	Regulators able to force shedding of business lines, products	Fed, FDIC	Rule in force	December 31, 2013
Intermediate Holding Company (IHC)	Banks	U.S. subsidiaries of foreign banks are undercapitalized for their potential risk, allowing for a regulatory arbitrage with U.S. banks	U.S. subsidiaries of foreign banks exiting U.S. market	Fewer counterparties with repo capacity; less liquidity	Fed	Final rule released	July 1, 2016
G-SIB Capital Surcharge	Banks	The largest banks are so large and systemically important on a global scale, they need another layer of capital	Largest banks forced to hold more capital, especially if they use short-term funding	Market share shift to regionals	Fed	Final rule released	January 1, 2019
Total Loss Absorbency Capital (TLAC)	Banks	Banks failed during the financial crisis because they could not raise capital	More longer-term debt issued by banks that can be converted to capital	Increased funding costs for G-SIFIs	Fed	Draft rule proposed	January 1, 2022 (proposed)
Margin Requirements for Short-Term Funding	Shadow banking	Too much risk is being taken in short-term wholesale funding	Increase in non-agency repo cost	Decreased liquidity	Fed	Not yet proposed	2018 (est.)
Volcker Rule	Banks, Insurers	Banks using proprietary information to trade against clients' best interests	Elimination of bank proprietary trading desks	Reduction in secondary liquidity could affect M2M	Fed, FDIC, OCC, SEC, CFTC	Rule in force	July 1, 2015
Risk Retention	CRE mREITs	Securitizers do not have enough 'skin in the game' and have not been an effective check on the system	Securitizers must hold share of risk	Higher yields in ABS market; reduced capital in B-piece market	Fed, FDIC, OCC	Final rule released	December 24, 2016
Nonbank SIFI designation	Insurers, asset managers	Certain nonbank financial firms do not have sufficient federal regulation	Designated firms may need to hold more capital	Uneven playing field vs. non-designated firms	FSOC, Fed	Authority effective, capital standards pending	May, 2012
Fundamental Review of the Trading Book	Banks, Shadow banking	VAR models do not accurately reflect risk in trading books	Overhaul of risk measurement	Could prompt selling non-agency inventory, negative M2M impact for mREITs	Basel	Proposed framework released	January, 2018 (targeted)
Guidance on Commercial Real Estate Lending	Banks, CRE mREITs	Possible asset bubble in CRE/are banks taking on too much risk	More scrutiny on banks making CRE loans	Banks less willing to make CRE loans, market share shift to mREITs	Fed, FDIC, OCC	Document released	December, 2015
Guidance on Leveraged Loans	Banks	Banks taking on too much risk in the loans they provide for buyouts	More scrutiny on banks making leverage loans	Banks less willing to make leveraged loans, fewer leveraged buyouts	Fed, FDIC, OCC	Document released	March, 2013
Money Market Fund Reforms	Money market	Fixed NAV provides false assurance that funds will not 'break the buck'/concerns about runs when NAV falls below $1	Funds pushed to more liquid collateral	Funds could become repo counterparties	SEC	Final rule released	July, 2016
Liquidity Rules for Asset Managers	Asset Managers	Fund managers will not be able to meet redemptions if there are mass redemptions/reducing confidence in mutual funds/ETFs	Shift funds toward more liquid securities	Increased cost of capital for smaller companies; negative impact on bond fund ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Derivative Rules for Asset Managers	Asset Managers	Fund managers taking on too much risk/juicing performance with over reliance of derivatives	Derivative limits for funds	Lower returns for funds; decrease in leveraged ETFs	SEC	Draft rule proposed	2016-2017 (est.)
Stress Tests for Asset Managers	Asset Managers	A failure of an asset manager would shake confidence among retirement savers	Potential higher capital standards and limitations on capital management for asset managers	Could lower returns for funds	SEC	Not yet proposed	2017 (est.)
Additional Rules for Asset Managers	Asset Managers	Current regulations of asset managers have not been updated to reflect their risks	Heightened scrutiny on asset managers, potentially limiting business activities	Could lower returns for funds	SEC	Not yet proposed	2018 (est.)
Fiduciary Standard Rule	Insurers, Asset managers	Investment advisors are not acting in the best interest of their clients	Move all brokers to 'best interest' standard	Lower profitability for broker/dealers and asset managers; limited buyers for certain assets	SEC	Not yet proposed	TBD
Block Trade TRACE Reporting	Banks/Bond trading, Insurers	More transparency is needed in bond market trading	Block trades must be disclosed within 15 minutes	Reduced liquidity and larger bid/ask spreads on FI products; could impact M2M	FINRA	Rule in force	January, 2015

Source: FBR Research

Appendix F: Relevant Regulations and Impacts

The below explanation of the regulatory regime has been excerpted from the CRE Finance Council regulatory impact study Regulatory Design, Real Outcomes that was published in November 2015.

- The Group of 20 (G20) added financial institution regulation to its agenda in 2009 and designated the Financial Stability Board (FSB) to oversee implementation of extensive remediation that regulators sought in response to the financial crisis.
- In the United States, much of the regulatory agenda is embodied by the Dodd-Frank Act, though policy makers are rolling out additional planks of the G20 agenda outside of Dodd-Frank.
- Much of this regulation applies to the CRE sector, including capital, liquidity, risk retention, Volcker, some asset management requirements, and various reporting and disclosure rules.
- Going forward, there are material changes to come for the CRE sector:
  - Basel III remains a work in progress.
  - Newer elements of the regulatory agenda, especially those extending to the asset management sector and to short-term financing, have not yet been exposed.
  - The question of how regulators will treat systemically important financial institutions (SIFIs) and how that regulation may impact the flow of funds to and within the CRE sector remains a key consideration for the industry.
- While major questions regarding regulatory intent remain to be answered, CRE market participants have observed that questions regarding unintended consequences often arise during the implementation phase. This means that even after a rule is published, the

industry requires a period of dialogue with the regulators to answer outstanding questions of interpretation.

- As the regulatory conformance schedule in the U.S. currently extends into 2019, it is likely that the industry will be absorbing major changes from new rulemaking and implementation into the next decade.

For the CRE bank lending sector, capital and liquidity requirements present the greatest financial challenges of the new rules. For the CMBS sector, the credit risk retention rule is the biggest game changer. As of this writing, Basel III capital and liquidity rules are still evolving, and the credit risk retention (CRR) rule will go into effect late in December 2016. Though the Volcker rule allows CMBS underwriting, it restricts secondary trading to market making. Other meaningful rules, such as Volcker, are in effect or going into effect shortly.

Going forward, the regulators are shifting their focus and plotting course on a number of nonbank fronts. Because much of the crisis can be traced to "liquidity transformation", or the use of short-term debt to fund longer term assets, the regulators have aggressively addressed these activities within the banking sector already, but intend to extend requirements and oversight to bilateral repurchase agreements (i.e., those that occur outside of the banking system) and possibly to other types of short-term financing.

Collectively, the regulators are also in the beginning phases of articulating priorities around the asset management industry as a whole, though the SEC did finalize rules related to the money market mutual funds already in 2014. In addition, SEC commissioners have mentioned consideration of requirements relating broadly to portfolio composition, risk management and stress testing.

Finally, the agencies continue to work slowly through the questions of SIFI designation and treatment. As of this writing, the authorities have decided to pursue regulation of asset management activities instead of designations, though they hold out the possibility of also designating asset managers and subjecting them to prudential requirements. Because the systemically important insurers (SIIs), many of which have been designated already, and the potential asset manager SIFI designees are prominent CRE lenders and investors, the issue is an important one to the sector. Not only can new requirements influence business strategy at these firms, but they can influence activities across the sector indirectly.

SII capital and liquidity treatment has not been proposed here in the U.S. However, for these institutions, rating agency requirements have represented binding requirements, or the outer bound threshold. Until new regulatory rules have been rolled out in the US, it is not clear which regime will present the strictest set of requirements.

Perhaps the most prominent regulatory issue at this time is the matter of market making and liquidity. Many rules affect the willingness of bank dealers to support secondary market trading, including Volcker, risk based capital, the liquidity coverage ratio, the leverage ratio (which impacts the repo market), and others. Over the course of 2014 and 2015 public discourse on the nature of liquidity and the sources of its contraction has moved between regulators, Congress, business leaders, and the press. For CMBS, turnover volume remains lower than during the crisis, suggesting that the market is indeed structurally different since rulemaking. Market participants generally cite requirements around capital and repos as the primary drivers of the dealers' pullback on balance sheet allocation to the business.

What follows below is a brief set of explanations of rules and other regulatory activities:

Credit Risk Retention (CRR)

The CRR rule, which requires that all sponsors (or B-piece buyers) hold 5% of a transaction for at least five years, was adopted at the end of 2014 and becomes effective at the end of 2016. It is alternately called the "eat-your-own-cooking" rule and is intended to achieve better underwriting in CMBS pools. The requirement is expect to add costs of 10 bps to 50 bps under (2015) conditions.

Revisions to Basel III Risk-Based Capital

The Basel Committee on Banking Supervision (BCBS) is actively revising the foundational concepts underlying the risk-based capital framework and will likely produce final versions of several new standards late in 2015 and early in 2016.

Initiatives regarding capital floors, treatment of credit risk (portfolio lending) and securitizations will impact costs across CRE business lines at large- and medium-sized banks in the future. Based on some industry analysis produced in relation to the BCBS document, "Revisions to the securitisation framework", we believe that for commercial asset classes with maturities of five years or more, higher capital requirements are expected for most tranches.

The BCBS is also finishing work on the "Fundamental review of the Trading Book" (FRTB), which applies to all assets held for market making purposes. As of this writing (4Q15), the FRTB work stream is possibly one of the most controversial aspects of rulemaking financial system-wide. On average, the requirements as proposed will more than double capital charges for senior and junior bonds, and will be particularly onerous for CMBS as compared to other asset classes. Based on an informal survey of the dealer community, there is a strong majority view that a material number of dealers would drop out of the market, and early estimates of bid-ask spread widening range of hundreds of basis points. Importantly, the industry would have to conform to these requirements after other rules enter into effect.

Basel III Liquidity Ratios

Basel III mandates that large banks adhere to two liquidity ratios—the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR was adopted in 2014 and went into effect at the beginning of 2015. Meanwhile, US regulators are expected to propose the NFSR in (2016).

The LCR adds costs to whole loans that have drawdown features, such as construction loans. The rule also disadvantages private-label and some GSE-sponsored CMBS. Where banks had used CMBS to help manage their asset and liability (ALM) exposures (the difference in duration between their assets and their liabilities), the rule excludes the vast majority of CMBS from the High Quality Liquid Asset (HQLA) designation, which is becoming fairly synonymous with banks' ALM portfolios.

Based on the BCBS's final standards regarding the NSFR, it appears that this rule when adopted in the US will likely add operating costs to balance sheet loans.

Volcker Rule

The Volcker Rule is impacting the industry on many levels. While CMBS are generally allowed under the rule, and most CRE whole loans appear not to be subject to the trading restrictions, the Volcker rule will require the support of substantial infrastructure representing an ongoing cost of doing business.

Registration and Disclosure Rules

New shelf registration requirements and Regulation AB II and other reporting requirements will add costs to CMBS. The new shelf registration requirements will add an estimated $20,000 per transaction, according to a senior partner at a law firm. FINRA reporting requirements are considered to contribute to reduced secondary trading liquidity.

Total Loss Absorbency Capital

The first international level proposal for Total Loss Absorbency Capital (TLAC) was published by the Financial Stability Board (FSB) at the November 2014 G20 Summit. TLAC essentially acts as a capital floor for large banks and would override risk-based capital at the holding company level, requiring that large banks hold 16% to 18% capital and high-quality debt, not including buffers. Based on analysis performed by The Clearing House, the FSB's proposal will require that banks establish a cushion that is 2.6x to 5.2x the historical need for capital in a crisis.

The Federal Reserve adopted a final rule relating to part of the TLAC, which established the capital base according to the leverage requirements (total assets to risk-based capital) at 2x the international standards for global systemically important banks (G-SIBs).

Appendix G:

Outstanding Loan Balance: Idaho, Massachusetts, Virginia; Data provided by Trepp

Idaho			
Loan Status	**Loan Count**	**Current Balance**	**%**
Current	261	1,181,667,793	99.2%
Performing Beyond Maturity			0.0%
30 Days			0.0%
60 Days			0.0%
90+ Days			0.0%
Non-Performing Beyond Maturity			0.0%
Foreclosure			0.0%
REO	3	9,638,482	0.8%
Total	**264**	**1,191,306,275**	**100.0%**

Idaho	
# Loans	264
Current Bal	1,191,306,275
Avg DSCR	1.57
Avg LTV	69.24

Idaho			
Property Type	**Loan Count**	**Current Balance**	**%**
Coop Housing			0.0%
Industrial	4	16,597,211	1.4%
Lodging	15	119,117,885	10.0%
Multifamily	147	483,470,743	40.6%
Mixed-Use	6	27,285,035	2.3%
Office	13	156,872,960	13.2%
Other	37	109,583,551	9.2%
Retail	36	265,538,679	22.3%
Self Storage	6	12,840,212	1.1%
Total	**264**	**1,191,306,275**	**100.0%**

Idaho			
Orig Year	**Loan Count**	**Current Balance**	**%**
1997			0.0%
1998	1	930,938	0.1%
1999	1	1,394,621	0.1%
2000			0.0%
2001	3	2,105,025	0.2%
2002	1	654,977	0.1%
2003			0.0%
2004	3	21,314,521	1.8%
2005	3	7,767,710	0.7%
2006	13	101,128,019	8.5%
2007	41	261,689,021	22.0%
2008	3	4,392,218	0.4%
2009	2	4,146,955	0.3%
2010	7	28,232,572	2.4%
2011	16	59,249,427	5.0%
2012	14	67,739,837	5.7%
2013	44	179,644,273	15.1%
2014	42	154,890,719	13.0%
2015	50	215,439,318	18.1%
2016YTD	20	80,586,127	6.8%
Total	**264**	**1,191,306,275**	**100%**

Massachussetts			
Loan Status	**Loan Count**	**Current Balance**	**%**
Current	1,320	17,062,084,814	97.4%
Performing Beyond Maturity			0.0%
30 Days			0.0%
60 Days	2	29,460,179	0.2%
90+ Days	2	12,880,289	0.1%
Non-Performing Beyond Maturity	1	8,555,719	0.0%
Foreclosure	6	107,914,717	0.6%
REO	15	289,526,645	1.7%
Total	**1,346**	**17,510,422,363**	**100.0%**

Massachussetts	
# Loans	1,346
Current Bal	17,510,422,363
Avg DSCR	1.65
Avg LTV	71.06

Massachussetts			
Property Type	**Loan Count**	**Current Balance**	**%**
Coop Housing	1	903,210	0.0%
Industrial	44	527,395,280	3.0%
Lodging	33	1,104,117,588	6.3%
Multifamily	787	6,581,421,689	37.6%
Mixed-Use	28	1,396,641,242	8.0%
Office	96	4,235,285,910	24.2%
Other	178	947,368,552	5.4%
Retail	154	2,604,549,494	14.9%
Self Storage	25	112,739,398	0.6%
Total	**1,346**	**17,510,422,363**	**100.0%**

Massachussetts			
Orig Year	**Loan Count**	**Current Balance**	**%**
1997			0.0%
1998	11	20,443,927	0.1%
1999	5	3,599,060	0.0%
2000	1	664,108	0.0%
2001			0.0%
2002	3	2,257,861	0.0%
2003	5	14,916,727	0.1%
2004	19	273,644,228	1.6%
2005	15	193,228,136	1.1%
2006	76	1,486,142,180	8.5%
2007	133	3,648,820,651	20.8%
2008	17	119,457,505	0.7%
2009	17	167,105,731	1.0%
2010	39	432,343,646	2.5%
2011	60	912,951,257	5.2%
2012	119	1,610,374,642	9.2%
2013	193	2,547,881,026	14.6%
2014	242	2,371,090,256	
2015	271	2,085,006,065	
2016YTD	119	1,617,494,014	9.2%
Total	**1,345**	**17,507,421,019**	**75%**

Virginia			
Loan Status	Loan Count	Current Balance	%
Current	2,220	26,387,324,787	94.2%
Performing Beyond Maturity	2	44,652,972	0.2%
30 Days	3	113,133,205	0.4%
60 Days	1	14,549,522	0.1%
90+ Days	1	2,725,026	0.0%
Non-Performing Beyond Maturity	4	32,480,578	0.1%
Foreclosure	17	670,870,890	2.4%
REO	35	735,981,181	2.6%
Total	2,283	28,001,718,159	100.0%

Virginia			
Property Type	Loan Count	Current Balance	%
Coop Housing			0.0%
Industrial	56	469,497,998	1.7%
Lodging	161	1,964,333,665	7.0%
Multifamily	1,268	13,220,794,464	47.2%
Mixed-Use	30	526,801,305	1.9%
Office	208	5,807,665,413	20.7%
Other	181	821,741,297	2.9%
Retail	332	4,949,167,296	17.7%
Self Storage	47	241,716,720	0.9%
Total	2,283	28,001,718,159	100.0%

Virginia	
# Loans	2,283
Current Bal	28,001,718,159
Avg DSCR	1.56
Avg LTV	73.79

Virginia			
Orig Year	Loan Count	Current Balance	%
1997	7	27385276.73	0.1%
1998	25	38353782.42	0.1%
1999	13	27045940.2	0.1%
2000	1	6583658.81	0.0%
2001	1	462,302	0.0%
2002	4	2,237,925	0.0%
2003	19	34,545,914	0.1%
2004	26	284,169,296	1.0%
2005	33	212,483,976	0.8%
2006	164	2,278,302,118	8.1%
2007	284	5,347,515,548	19.1%
2008	32	328,847,048	1.2%
2009	7	163,122,723	0.6%
2010	44	447,616,044	1.6%
2011	111	2,108,556,668	7.5%
2012	192	2,607,747,745	9.3%
2013	333	4,261,706,977	15.2%
2014	364	3,182,714,576	
2015	425	4,431,304,353	
2016YTD	198	2,211,016,289	7.9%
Total	2,283	28,001,718,159	73%

Appendix H: Overview of Regulatory Process – International and Domestic

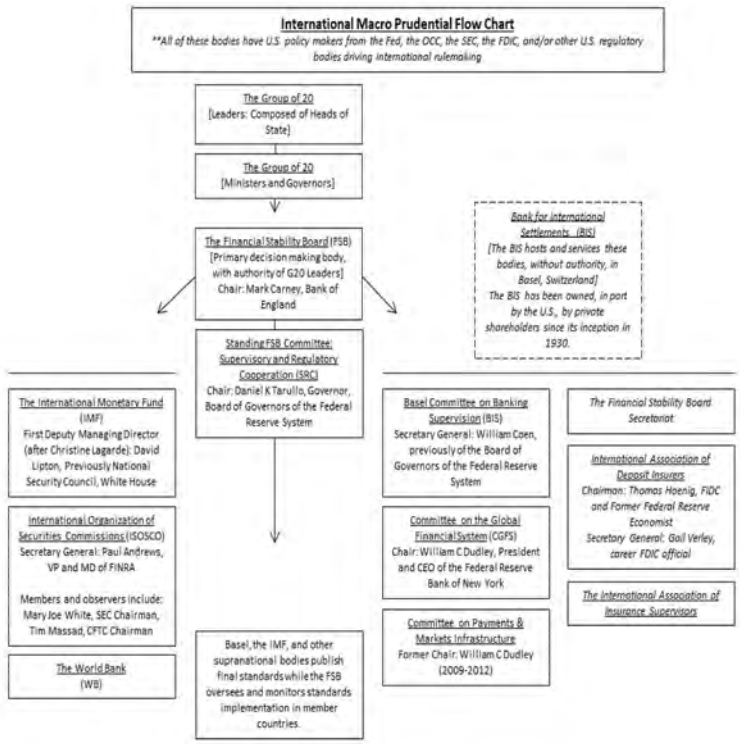
fter the financial crisis, the banking industry and the media focused on the new capital and liquidity requirements the Basel Committee for Banking Supervision (BCBS) passed on to U.S. regulators through Basel III. The international regulatory infrastructure is much more layered than is widely known and yet, it is also heavily influenced by U.S. policy-making goals. Today, the BCBS and similar standard setting bodies answer to two supranational groups, the Group of Twenty (G20) and the Financial Stability Board (FSB), which often draw their leadership from the Federal Reserve System (FRS) and other U.S. agencies. Additionally, officials from the Federal Deposit Insurance Coporation (FDIC), Office of the Comptroller of the Currency (OCC), Securities and exchange Commission (SEC), and other regulatory bodies often contributed to and even led the development of the regulatory agenda internationally, directly contributing to the increase in capital and liquidity standards contained in Basel III and other rules being adopted at home. Essetially, the G20 and FSB act as the executive, decision-making arm that sets the international agenda, while the various Basel committees consult, research, and publish the rules that carry out these international regulatory goals.

What is the Systemic Risk Agenda? Who are the Macro Prudential Regulators?

In the post-financial crisis era, nations recognized and felt the impact and toxicity of excess financial leverage. Rightfully so, leaders called for a coordinated response effort, and more importantly, a framework to prevent similar crises in the future. The largest nations and emerging market economies under the leadership of the G20, met to expand existing supranational regulatory bodies as well as create new ones. Collectively, these nations set out to weed out systemic risk and promote economic growth and stability.

Since 2009, an aggregation of supranational bodies led by the FSB, with the distinct power granted by the leaders of the G20, leads the international regulatory rulemaking, implementation, and oversight process. Organizations, including the BCBS, International Organization of Securities Commissions (ISOCO), Bank for International Settlements (BIS), Committee on the Global Financial System (CGFS), The World Bank (WB), and the International Monetary Fund (IMF), all serve various decision-making, research, implementation, and oversight roles within, but underneath, the supervision of the G20 and the FSB.

No single nation is "in charge" and no single body exists to implement policy or regulations from the international level; individual jurisdictions are responsible for tailoring and adopting requirements through their own legislative and / or rulemaking frameworks. Sovereign nations are responsible for implementing and monitoring their own capital, liquidity, and risk management rules across their banking and financial services industries. With each subsequent international financial crisis, supranational standard setting bodies have emerged with more influence and the ability to create "soft law" in the wake of financial turmoil.



The Group of 20 (G20)

The G20 is generally considered one of the preeminent organizations on international matters, especially international financial regulation. Self-appointed in 2009, the body expanded upon the G7 to include larger developing economies in order to better account for systemic risk, and includes the 19 member countries plus the European Union (EU). G20 member countries account for 86% of global GDP, 90% of global banking assets, and 94% of the global bond market.

The G20 is split among two levels: 1) G20 Leaders, made up of heads of state; and 2) G20 Governors, made up of central bankers and treasury officials and their equivalents. The leaders meet on a near-annual basis to review work of the G20 Ministers and set the agenda for the ministers' future work, while ministers execute the Leaders' agenda on an ongoing basis.

Financial Stability Board (FSB)

The FSB is the primary global decision making body, and has been since the G20 created the FSB in 2009 to coordinate international financial regulation.

> "The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard setting bodies as they work toward developing strong regulatory, supervisory and other financial sector policies…the FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities."

The FSB Charter derives its authority from the G20 Leaders' statement explaining that the FSB should be "given a broadened mandate to promote financial stability, and re-established with a stronger institutional basis and enhanced capacity" including responsibilities such as reviewing, coordinating, and addressing gaps among the "international standard setting bodies" (i.e., Basel, etc.) and "oversee action needed" to address financial system vulnerabilities."

The FSB's previous iteration, the Financial Stability Forum, served a consultative function with international standard setting bodies. However, in 2009, the heads of state of the largest economies of the world improved the FSB's mandate to implement the overarching regulatory agenda and ensure implementation of the rules published by international standard setting bodies.

The FSB is currently chaired by Mark Carney, Governor of the Bank of England. Carney directs the Plenary, a committee of 69 members from FSB member countries, international financial institutions, and international standard setting bodies. Members of the Plenary include representatives from the G20 countries, the World Bank, the IMF, the BIS, the ECB, the European Commission, the BCBS, the IAIS, IOSCO, IASB, CGFS, and the OECD.

The Secretariat of the FSB is located in Basel, Switzerland, and is hosted by the Bank for International Settlements. The Secretariat has 33 members and supports the policy development and activities of the FSB. The Secretariat is noted here because of its proximity and closeness to the "Basel Process," explained in the next section. The proximity and location of the FSB in Basel further engenders the close thinking of the economists, central bankers, and regulators that work out of the various committees hosted by the Bank for International Settlements.

The Bank for International Settlements (BIS)

The Bank for International Settlements hosts a number of international standard setting bodies – notably the Basel Committee on Banking Supervision and the Committee on the Global Financial System – that are physically housed at the BIS facilities. In fact, all but IOSCO are located in Basel.

The best-known committee, the BCBS, was formed in 1974 by the Group of 10 (G10) in the wake of economic turmoil – the collapse of fixed exchange rates, rising oil prices, interest rate fluctuations, and bank failures. Prior to the creation of the BCBS, the BIS served as an international meeting place and information exchange for central bankers. It became the supranational regulatory body it is today in the early 90's after the Federal Reserve formally joined the Basel Process and the BIS.

BCBS membership includes central banks and regulatory authorities (in the U.S.: FRS, OCC and FDIC); and other international groups including the BIS, the IMF, the Basel Consultative Group (a liaison group to non-members), the European Banking Authority, and the European Commission. "The Basel Process is based on three key features: synergies of co-location, flexibility and openness in the exchange of information, and support of the BIS's expertise in economics, banking, and regulation."

BIS Ownership and Founding

The BIS is a private, for-profit firm. It was created principally as a bank – to take deposits and make loans, while providing trustee and agent services for its central bank clients. It formed in 1930 as a commercial bank with public shares, which were primarily offered to central banks. Eighty-six percent of BIS stock is owned by central banks while 14% is owned privately by public shareholders. Ownership entitles shareholders to dividend payments but only member central banks are entitled to sit on the BIS board or attend board meetings – which are notoriously secretive making its importance and banking services difficult to quantify.

Today, the U.S. sits on the board of BIS and has since 1994 when it quietly joined the organization. In 1930, the Federal Reserve was barred from owning shares or from formal BIS board participation, instead, shares were held in a trust by First National City Bank.

Importantly, the bank's charter and statutes explicitly state that the bank was set up to execute the monetary policy of its member banks. If a member bank disagrees with a financial transaction that the BIS plans to execute, member banks (who collectively own the BIS) have the ability to dissent and stop a transaction.

International Organisation of Securities Commissions (IOSCO)

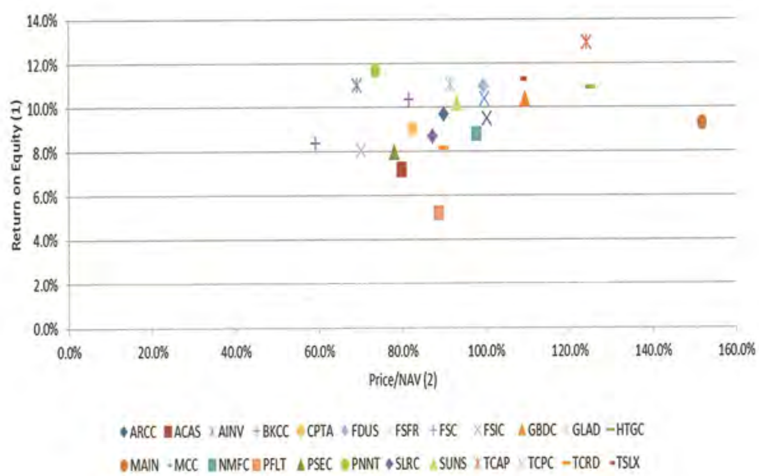
The International Organisation of Securities Commissions, also known as IOSCO, is the international body that connects the world securities' regulators – in the U.S., the Securities and Exchange Commission. It was established in 1983 and operates out of Madrid, Spain – a notable departure from most of the standard-setting bodies based out of Basel.

The organization's stated purpose is to maintain fair and transparent markets while addressing systemic risks. It is governed by the ISOSCO board, comprised of 33 securities regulators, including Tim Massad, Chair of the CFTC, and Mary Jo White, Chair of the SEC.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN CRAPO FROM MICHAEL J. AROUGHETI

Q.1. Can you explain the impact of the ROE for BDC investors and how operating efficiently as a BDC structure can help investors earn better returns, especially compared to other financial services companies or products?

A.1. A higher return on equity for a BDC translates into higher dividends for investors (due to the pass through nature of the earnings) and potentially growth in net asset value for the BDC. Research has shown that higher ROEs typically translate into improved stock price valuations for BDCs (see chart below). By operating more efficiently, a BDC can improve its ROE. There are several ways a BDC can improve its ROE through efficient operations: (1) given the positive spread between asset yields and borrowings, higher leverage results in improved ROEs, (2) increasing asset yields or reducing funding costs can improve ROE, (3) increased scale in assets can improve ROE as greater interest income is spread over some fixed operating costs.



1. Calculated using the last four quarters NOI (for all companies except ARCC which used core EPS) divided by average book value per share.
2. Based on stock price as of May 31, 2016 and NAV for most recently reported quarter.

Over the last 2 years, large BDCs have generated higher returns on equity than comparable mid-size banks. As the chart below indicates, large BDCs have averaged returns on equity of over 9 percent compared to return on equity for the KBW mid-cap index ranging from 7.6 percent to 8.5 percent.

Return on Equity Comparison*

	2014	2015
BDC Peer Group[(1)]	9.52%	9.26%
KBW Mid-Cap Bank Index[(2)]	7.62%	8.49%

* Calculated using the last four quarters NOI divided by average book value per share.

1. BDC Target Group includes BDCs with market capitalization greater than $300 million including ACAS, PSEC, FSIC, AINV, MAIN, FSC, TSLX, NMFC, GBDC, GSBD, HTGC, TCPC, SLRC, BKCC, TCAP, PNNT, MCC, TCRD, and TICC.
2. Calculated using the equally weighted average of the KBW Regional Bank Composite, which includes 50 regional banks with market capitalization ranging from $0.7 billion to $5.9 billion as of December 31, 2015.

BDCs have historically generated higher ROEs using less leverage. As the table below indicates, BDCs operate with average assets to equity of 1.89x compared to 8.88x for BBB Banks. In addition, the BDCs have favorable efficiency ratios compared to the banking sector.

	BDC Peers[2]	BBB Bank Index [3]	CIT	ALLY	ARCC
Assets / Equity[1]	1.89x	8.88x	6.03x	11.32x	1.81x
Efficiency Ratio – LTM[4]	76.59%	62.08%	64.62%	68.27%	37.68%

1. Sources: SNL and Financial Statements. Data as of 3/31/16 unless otherwise noted. Third party information has not been independently verified by ARCC.
2. Selected peers includes BDCs with investment grade notes outstanding. Includes Fifth Street Finance, FS Investment Corp, Pennant Park, Prospect Capital, Main Street Capital and Apollo Investment Corp.
3. BBB Bank Index includes Associated Bancorp, Astoria Financial, Capital One, Discover Financial, Fifth Third Bancorp, First Horizon, Huntington Bancshares, KeyCorp, Regions Financial, SunTrust Bank, SVB Financial and Zions Bancorp.
4. LTM noninterest expense before foreclosed property expense, amortization of intangibles, and goodwill impairments as a percent of LTM net interest income and noninterest revenues, excluding only gains from securities transactions and nonrecurring items. For ARCC, amounts also exclude the capital gains incentive fees accrued under GAAP.

Q.2. During the hearing there was some discussion over whether institutional investors are more or less active in the BDC space. What is the data over the last 5 years?

A.2. Institutional investors are still a very meaningful owner in the BDC sector and there has not been a mass exit of actively managed institutional accounts. In March 2014 the passive investment funds that tracked the Russell 2000 had to exit the space due to the removal of BDCs from the Russell indices. The removal was related to pressure exerted on the Russell by large passive funds and the additional fee calculations that were required with BDC ownership. While the removal was unfortunate (and ill-advised) it did not impact the majority of institutional investors for Ares, but it did have an impact on the majority of the BDC industry, triggering a 25 percent reduction across the industry.

Figure 1 provides data on institutional ownership in the BDC sector ($ ownership and average # of accounts). We would note that the number of institutional owners has increased but the $ amount in the sector has declined. We attribute the decline to two factors: (1) 10–12 percent of the sector holdings were in passive funds that exited BDCs in 2014 due to the Russell index exclusion and, (2) three of the BDCs in the data set (AINV, FSC, PSEC) have experienced significant issues post the recession and have price declines of -62 percent, -52 percent, -40 percent, respectively. Excluding these outsized price declines the institutional ownership in the data set increased on a dollar basis by +16 percent over the past 5 years (even with the Russell exclusion). Institutions are not avoiding fundamentally strong BDCs.

Figure 1 – Institutional Ownership over 5yr Period*

	March 2016	March 2011	% Change
Total Institutional $ Holdings	$5,483,628,235	$6,384,168,293	(14%)
Average # of Institutional Holders	194	159	22%

Source: SNL

*Top 10 BDCs in market cap that were public at both time periods, excluding ACAS due to increased institutional shareholder base related to M&A expectation. Data includes ARCC, PSEC, MAIN, AINV, GBDC, HTGC, FSC, TCAP, SLRC, and BKCC.

Q.3. How does a registered investment advisor (RIA) help a BDC fulfill its core mission of providing capital for growing small- and middle-market companies and what guard rails might help ensure that it is not used for purposes well beyond the BDC's core mission?

A.3. The proposed bill would allow BDCs to own registered investment advisers, which as a technical matter is currently prohibited under the 1940 Act. Investments in RIAs owned by BDCs serve as an extension of the BDCs' mission to raise capital from third party investors and then, in turn, deploy that capital to small- and medium-sized companies. For example, a large institutional investor may desire to make investments in small- and medium-sized U.S. private companies, but is unable to (or prefers not to) make such investments through the equity of a publicly traded entity such as a BDC. Finally, it is important to note that BDCs are currently able to, without restriction, own unregistered investment advisers.

The SEC has recently issued exemptive orders on this topic, which include very specific conditions to be satisfied in order for a BDC to own, make investments in and grow an RIA. We believe that these conditions create sufficient existing "guardrails" to ensure that a BDC-owned RIA remains, as a general matter, focused on the BDC's core mission, stated investment objective, and Congress's 1980 mandate to create BDCs.

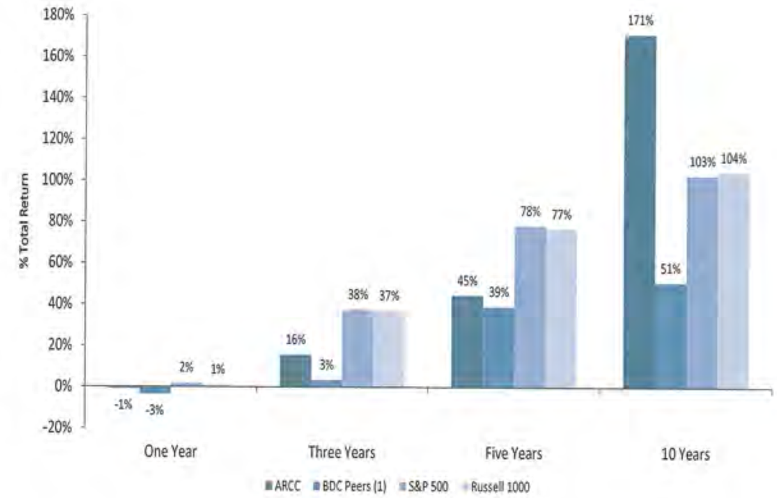
Q.4. BDCs are investment vehicles open to retail or "mom and pop" investors. What has been the overall return to a retail investor in the BDC sector over the last 1, 3, 5, and 10 years, and can you compare it to other benchmarks?

A.4. BDCs only have one class of stock (per regulation) and are attractive investment vehicles for both retail and institutional investors. The return to the retail investor and the institutional investor is exactly the same; there is no preferential treatment for either investment group. Figure 2 below provides the total return in ARCC stock since IPO relative to the Wells Fargo BDC Index and the S&P 500.

Figure 2 – Total Return for Investors in ARCC since IPO

1. Source: SNL Financial. Total return on security or index with dividends; assumes dividends are reinvested at the closing price of the security on the ex-date of the dividend. Past performance is not indicative of future results.
2. S&P LSTA LLI is a broad index tracking the U.S. loan market and the Credit Suisse Leveraged Loan Index is a broad index tracking the non-investment grade bank loan market.

The chart below highlights ARCC and BDC sector total returns to investors over the last 1, 3, 5, and 10 year periods.



Note: All data as of June 2, 2016. Past performance is not indicative of future results.

1. BDC peer group consists of BDCs with market capitalization or an investment portfolio of $500 million as of December 31, 2015 or greater or who are under common management with a BDC that meets these criteria. Peers include ACAS, AINV, BKCC, CPTA, FSC, FSFR, GBDC, GSBD, HTGC, MAIN, MCC, NMFC, PFLT, PNNT, PSEC, SLRC, SUNS, TCAP, TCPC, TCRD, and TICC.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM STEPHEN W. HALL

Q.1. During the hearing, there was discussion of the upcoming SEC rules requiring a floating net asset value (NAV) for institutional prime and municipal money market funds (MMFs). In particular, it was suggested that a floating NAV would reduce investor demand for municipal MMFs and then reduce demand for short-term obligations of municipalities. It was argued that these changes could raise municipalities' borrowing costs.

Based on any publically available information, please describe your understanding of the assets under management (AUM) of (i) all municipal MMFs, (ii) institutional municipal MMFs (which will have a floating NAV under the new rules) and (iii) retail municipal MMFs (which will not be subject to a floating NAV). Please also discuss the market that retail and institutional municipal MMFs serve, in particular the identities of the purchasers of the funds and investments of the funds.

A.1. *Recent data confirm that the floating NAV will have little if any impact on municipal financing*—Table 1 below sets forth information about the level of investment by institutional municipal MMFs in municipal debt. It confirms one of the key points that the SEC highlighted when it issued its rule implementing the floating NAV. In its 2014 release explaining the final rule, the SEC observed that the upcoming transition of institutional municipal MMFs to a floating NAV would likely have a minimal impact on municipal finance, because "institutional tax-exempt funds hold approximately 2 percent of the total municipal debt outstanding and thus *at most* 2 percent is at risk of leaving the municipal debt market."[1]

Recent data confirm this point and it is critical to a proper assessment of the impact of institutional municipal MMFs on municipalities' borrowing costs. As reflected in Table 1, institutional municipal MMFs currently hold even less of the total $3.7 trillion municipal debt market today than in 2014, now amounting to only 1.22 percent or $45.7 billion dollars. This means that the floating NAV will have an even more minimal potential impact on the borrowing cost of municipalities.

Table 1

Institutional Municipal MMF Investment in Municipal Debt (*in billions*)[2]	
Total Municipal Securities	$ 3,746.9
MMF Investment in Municipal Securities	$ 206.6
% of Institutional Municipal MMFs	$ 22.14%
Institutional Muni Investment in Municipal Securities	$ 45.74
% of Municipal Securities Held by Institutional Municipal MMFs	$ 1.22%

Recent trends in the level of investment in various types of MMFs support this conclusion. As reflected in Table 2 below, investment in all municipal MMFs has decreased somewhat over the last 6 months. However, the data suggest that this is not due to the floating NAV rule but is instead part of a broader trend. In fact, retail municipal MMFs have experienced a greater reduction in dollars invested than institutional municipal MMFs have experienced. Compare third and fourth columns in Table 2 (showing that nearly $3 billion more has been withdrawn from retail municipal MMFs than from institutional MMFs). Yet retail municipal MMFs will not be subject to the floating NAV, so the floating NAV cannot account for the decrease.

Furthermore, retail prime MMFs have also experienced a nearly 16 percent decline in investment dollars over the last 6 months. See sixth column of Table 2. They too will be exempt from the

[1] *SEC: Money Market Fund Reform; Amendments to Form PF* (p.255) (emphasis added).
[2] Data pulled from multiple publicly available sources are linked in this response.

floating NAV, further indicating that any decrease in municipal MMF investment is actually part of a larger trend affecting non-governmental MMFs, unrelated to the floating NAV. Any number of factors may be contributing to this trend, including a shift in demand due to ultra-low risk in government MMFs or recent volatility in the yields offered by MMFs.

Table 2

Assets Under Management *(in millions)* [3]	*All Municipal MMFs*	*Institutional Municipal MMFs*	*Retail Municipal MMFs*	*Institutional Prime MMFs*	*Retail Prime MMFs*	*All MMFs*
01/20/2016	$ 255,267	$ 68,624	$ 186,643	$ 783,307	$ 466,136	$ 2,742,488
06/08/16	$ 206,600	$ 45,739	$ 160,861	$ 730,299	$ 391,934	$ 2,725,398
Change (in $)	-48,667	-22,885	-25,782	-53,008	-74,202	-17,090
% Change	-19.07%	-33.35%	-13.81%	-6.77%	-15.92%	-0.62%
% of All Muni MMFs (1/20)		26.88%	73.12%			
% of All Muni MMFs (6/8)		22.14%	77.86%			
% of All MMFs (1/20)	9.31%	2.50%	6.81%	28.56%	17.00%	
% of All MMFs (6/8)	7.58%	1.68%	5.90%	26.80%	14.38%	

Even if the floating NAV were to have some dampening effect on the 1.22 percent invested in institutional municipal MMFs, it will not significantly reduce municipalities' access to financing. For example, even with the floating NAV in place, institutional investors will still have an incentive to seek out the beneficial tax exemptions associated with municipal MMFs. In addition, some investors may withdraw from institutional municipal MMFs but then migrate to retail municipal MMFs, causing no net change in funds invested in municipal MMFs. For example, as the SEC explained in the final rule, some retail investors currently invest in municipal MMFs through omnibus institutional accounts. Some estimates submitted to the SEC indicate that as much as 50 percent of the assets held in ostensibly institutional municipal MMFs are actually beneficially owned by institutions on behalf of investors.[4] To the extent the rule prompts them to withdraw from institutional funds, they are likely to reinvest in retail municipal MMFs, with no negative impact on municipal financing via MMFs.

Finally, any impact of the floating NAV must be viewed in a larger context. The reforms adopted by the SEC in its rule are nec-

[3] ICI Research and Statistics: "Release: Money Market Fund Assets June 9, 2016", and "Summary: Money Market Fund Assets Data (xls)".
[4] *SEC: Money Market Fund Reform; Amendments to Form PF* (p.247).

essary to help mitigate the risk of another devastating financial crisis.[5] In reality, as we explained in our testimony and in our comment letter to the SEC,[6] the SEC reforms are only a partial solution, and more needs to be done. But at least they begin to address the proven threat to financial stability posed by MMFs, as exemplified by the dramatic run on the Reserve Primary Fund during the 2008 financial crisis (see response to Question #2 below). The floating NAV is a critical element of those reforms. If it is rolled back, the risk of another devastating financial crisis, and its intensity, will increase. As we saw in 2008, such a crisis would throw all MMF markets into disarray, cause a massive and prolonged increase in unemployment, and ultimately devastate economic growth—to the detriment of local governments along with everyone else. The far wiser course is to allow all of the SEC reforms to go into effect, notwithstanding any minimal or speculative impact they may have on municipal financing obtained through MMFs.

Q.2. As discussed at the hearing, S. 1802 would allow MMFs of all types to use a stable NAV instead of a floating NAV. One witness, the Idaho State Treasurer, expressed concern that if prime institutional MMFs, which typically hold short-term corporate debt, are required to have a floating NAV, those funds could become less desirable and no longer satisfy his investment criteria. The impact on prime institutional MMFs may be difficult to quantify or predict, but those were among the investments that suffered significant distress during the financial crisis.

Based on reports or studies, including by the Department of the Treasury or the Securities and Exchange Commission, how did the financial crisis impact prime institutional MMFs? Specifically, please discuss any data that describes the "run" on prime institutional MMF assets. Also, what kinds of companies are the typical investments of prime MMFs?

A.2. *Part 1: The 2008 financial crisis crippled prime institutional MMFs, and a future crisis would have the same devastating impact*—The financial crisis made it painfully clear that MMFs present a serious risk of systemically significant runs and that those runs can cripple the short-term credit markets, potentially tipping the entire financial system into chaos. In the most compelling example of MMF run risk, the Reserve Primary Fund broke the buck on September 19, 2008, due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. This nearly unprecedented event happened even though Lehman-related assets comprised only 1.2 percent of the fund's total assets.

When the fund sponsors declined to provide support and priced its securities at $0.97 per share, a run immediately ensued. Within 2 days, investors sought to redeem $40 billion from the fund. This required the fund to sell tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemp-

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[5] "Better Markets, The Cost of the Crisis: $20 Trillion and Counting" (2015), available at *www.bettermarkets.com/costofthecrisis* (incorporated herein by reference as if fully set forth).

[6] Testimony of Stephen W. Hall, Better Markets, Inc., Before the Subcommittee on Securities, Insurance, and Investment of the U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Improving Communities' and Businesses' Access to Capital and Economic Development", May 19, 2016, at p.6 and n.11; Comment Letter From Better Markets to the SEC, Money Market Reform (Release No. 33-9408) (Sept. 17, 2013).

tions. This fire sale in turn depressed asset values, further weakening the fund. The run quickly spread to the entire prime MMF industry, and during the week of September 15, 2008, investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets.

That September, over 90 percent of the redemptions from prime MMFS were from institutional not retail funds. This caused immediate havoc in the short-term funding markets, triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. That month alone MMFs reduced their holdings of commercial paper by about $170 billion or 25 percent. [7] The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program for Money Market Funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis. [8]

Notwithstanding this unprecedented and massive intervention in what was then a $3.7 trillion market, the September 2008 run resulted in large and rapid divestment by MMFs in short-term instruments, "which severely exacerbated stress in already strained financial markets." [9] The decline in outstanding commercial paper contributed to a sharp rise in borrowing costs for commercial paper issuers. [10] In addition, while the losses ultimately sustained by investors in the Reserve Primary Fund were modest, those investors suffered substantial liquidity damage, losing access to their money for an extended period pending the outcome of judicial proceedings. [11]

The buckling of MMFs contributed heavily to the financial crisis, and all sectors of the economy paid a heavy price: "Regardless of which metric you look at—long-term unemployment, number of foreclosures, small business growth, Federal R&D spending—there is irrefutable evidence that the financial crisis of 2008 and the subsequent Great Recession have set the U.S. and tens of millions of Americans back like no other economic calamity since the Great Depression." [12] MMF reform is essential to prevent a recurrence. As stated by the SEC, "[w]ithout additional reforms to more fully mitigate the risk of a run spreading among MMFs, the actions to support the MMF industry that the U.S. Government took beginning in 2008 may create an expectation for similar Government support during future financial crises, and the resulting moral hazard may make crises in the MMF industry more frequent than the historical record would suggest." [13]

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[7] *SEC: President's Working Group Report on Money Market Fund Reform*, at 11-12 (Release No. IC-29497) (11/3/2010).

[8] See "SEC Division of Risk, Strategy, and Financial Innovation, Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher", at 12 (Nov. 30, 2012), available at *http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.*

[9] See generally "FSOC, Proposed Recommendations Regarding Money Market Mutual Fund Reform", 77 *FR* at 66,464 (Nov. 19, 2012) (FSOC Proposal).

[10] "FSOC Proposal", at 69,455, 69,458, 69,464; "Perspectives on Money Market Mutual Fund Reforms", Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 112th Cong. 6 (June 21, 2012) (Testimony of Mary Schapiro, Chairman, SEC) available at *http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=66f4ddb5-4823-4341-bad9-8f99cdf5fe9a* (Schapiro Testimony).

[11] Schapiro Testimony, supra n.8, at 6-7.

[12] Better Markets: "The Cost of the Crisis", at 95.

[13] "President's Working Group Report on Money Market Fund Reform", at 18 (Release No. IC-29497) (11/3/2010).

Part 2: The types of companies that are the typical investments of prime MMFs—The aggregated data from the SEC, reflected in Table 3 below, reveals that prime MMFs invest largely in private debt instruments but historically hold about 20 percent of assets in Government issuances. The 80 percent is invested in two types of nongovernmental obligations: certificates of deposits from banks and thrift institutions, and short term issuances including commercial paper and securities issued by financial institutions, securitizers, and nonfinancial institutions.

Table 3

Prime MMF Portfolio Composition (in millions)[14]	*Certificates of Deposit*	*Non-Financial CP and Other Short Term Securities*	*Gov't (Direct & Repo)*	*Financial Co. Commercial Paper*	*Asset Backed Commercial Paper*	*Total Amortized Cost*
4/30/2014	$ 615,826	$ 398,568	$ 366,015	$ 266,701	$ 100,270	$ 1,747,380
% of Total	**35.24%**	**22.81%**	**20.95%**	**15.26%**	**5.74%**	
4/30/2015	$ 564,264	$ 439,606	$ 350,540	$ 258,376	$ 90,277	$ 1,703,063
% of Total	**33.13%**	**25.81%**	**20.58%**	**15.17%**	**5.30%**	
4/30/2016	$ 633,856	$ 214,119	$ 296,882	$ 228,873	$ 93,903	$ 1,467,633
% of Total	**43.19%**	**14.59%**	**20.23%**	**15.59%**	**6.40%**	

[14] SEC Division of Investment Management: "Money Market Fund Statistics", at 13 (06/14/2016).

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT FROM LYNN FITCH, TREASURER, STATE OF MISSISSIPPI, SUBMITTED BY CHAIRMAN CRAPO

STATE TREASURY OF MISSISSIPPI

Lynn Fitch
STATE TREASURER

Senate Banking, Housing & Urban Affairs Subcommittee on Securities, Insurance & Investment

Improving Communities' and Business' Access to Capital and Economic Development
Thursday, May 19, 2016

The Honorable Lynn Fitch
Treasurer, State of Mississippi

Chairman Crapo, Ranking Senator Warner, and members of the Subcommittee. I appreciate the opportunity to provide this written testimony in support of the Consumer Financial Choice and Capital Markets Protection Act (S 1802), which is an essential remedy to a regulatory change that could negatively impact the ability of state and local government to invest in infrastructure needs.

At issue is a change in federal regulations for money market funds that will push all "institutional" investors into floating NAVs (net asset value), as opposed to stable NAVs, prime and tax-exempt money market funds.

For more than four decades, state and local governments have used money market funds for investment and cash management because of their liquidity, stability, efficiency, and returns. These benefits are largely a result of the funds' use of amortized cost accounting, offering investors a stable NAV per share. These funds have paid out higher interest to investors than comparable bank instruments. And, issuers can fund themselves at substantially lower rates than through bank loans because of their purchases of state and local debt as well as commercial paper.

Over their 40-plus-year history, only two money market funds have failed to return investors $1-per-share, known as breaking the buck. In fact, in the recent financial crisis, in which hundreds of banks failed, only one money market fund, the Reserve Primary Fund, "broke the buck."

Despite this history and despite overwhelming opposition during the public comment period, the SEC in July 2015 adopted by a vote of 3-2 rules that completely eliminate two categories of money market mutual funds that state and local governments often use. Unless Congress intervenes, beginning in October 2016, hundreds of billions in assets currently in stable NAV funds will be forced to move to alternative floating NAVs which are less transparent and less regulated, to systemically important banks, or to government money market funds which offer lower returns for investors. This change will effectively shrink the market for commercial paper and municipal debt, and raise borrowing costs for government issuers.

Overall, the American Society of Civil Engineers estimates that it will take \$3.6 trillion by the year 2020 to meet our nation's infrastructure needs. And, three-quarters of all public infrastructure projects in the U.S. are built by state and local governments.

According to the Mississippi Economic Council (MEC), my state alone will need an additional investment of \$375 million a year to address our most vital road and bridge needs. Now is certainly not the time to be cutting state and local government investment options short or to be limiting them to a lower return on their investments. Every penny saved in borrowing costs is a benefit to the people as both taxpayers and users of public infrastructure.

As your Subcommittee considers how best to improve communities' access to capital and economic development, please keep the simple remedy of S. 1802 in mind. Your support of that bill would be very much appreciated by communities across Mississippi and the rest of the nation.

LETTER FROM RICHARD JOHNS, EXECUTIVE DIRECTOR, STRUCTURED FINANCE INDUSTRY GROUP, SUBMITTED BY CHAIRMAN CRAPO

SFIG
Structured Finance Industry Group

May 18th, 2016

Chairman	Ranking Member
Securities, Insurance, and Investment	Securities, Insurance and Investment
Subcommittee	Subcommittee
534 Dirksen Senate Office Building	534 Dirksen Senate Office Building
Washington, DC 20510	Washington, DC 20510

Dear Chairman Crapo and Ranking Member Warner:

The Structured Finance Industry Group, Inc. ("SFIG") is a member-based trade industry group focused on improving and strengthening the broader structured finance and securitization market. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers and trustees.

SFIG's membership has divergent opinions on H.R. 4260, the *Preserving Access to CRE Capital Act of 2016*. SFIG's issuer and b-piece buyer members are supportive of an exemption for single-asset/single-borrower structures from the risk retention requirements for commercial mortgage-backed securities ("CMBS"), as well as a pari-passu structure for the b-piece retention option. At the same time, a majority of our investment-grade investors prefer the CMBS risk retention options as finalized under the risk retention rule, and do not support the modifications to the rule as written in H.R. 4260.

SFIG looks forward to tomorrow's hearing, and stands ready to work with the committee to find the broadest consensus possible on these important issues.

Sincerely,

Richard Johns
Executive Director
Structured Finance Industry Group

cc: Members of the Senate Subcommittee on Securities, Insurance and Investment

Structured Finance Industry Group • 1775 Pennsylvania Ave, NW, Suite 625, Washington, DC 20006 • (202) 524-6300

LETTER FROM THOMAS C. DEAS, JR., CHAIRMAN, NATIONAL ASSOCIATION OF CORPORATE TREASURERS, SUBMITTED BY CHAIRMAN CRAPO

May 18, 2016

The Honorable Mike Crapo
Chairman
Subcommittee on Securities, Insurance & Investment
Committee on Banking, Housing, & Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Mark Warner
Ranking Member
Subcommittee on Securities, Insurance & Investment
Committee on Banking, Housing, & Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Warner:

The National Association of Corporate Treasurers ("NACT") is comprised of treasury leaders from several hundred of the largest public and privately owned Main Street businesses across the country. As your subcommittee holds a hearing entitled "Improving Communities and Businesses' Access to Capital and Economic Development," we wish to express our support for S. 1802, the Consumer Financial Choice and Capital Markets Protection Act introduced by Senators Toomey, Manchin, Crapo and Menendez.

Institutional prime money market mutual funds (MMFs) have been a cornerstone of cash management for corporate treasurers whose primary responsibility is to manage significant cash fluctuations resulting from regular day-to-day business operations. MMFs are a preferred investment vehicle as they provide the benefits of liquidity, principal preservation, diversification, built-in credit analysis, and ease of accounting. There is no other option that provides the same level of benefit as a prime MMF. Additionally, prime MMFs have been significant purchasers of corporate commercial paper, providing efficient and attractive short-term capital to highly rated companies during times of cash shortfalls.

However, the Securities and Exchange Commission's new regulations for 2a-7 funds that come online in October will have very negative implications as the MMFs will move from a stable net asset value to a floating net asset value (NAV), presenting major tax and accounting complications to corporate treasurers. While IRS guidance allows the accounting for disposition of floating NAV MMF shares on an aggregate basis, they affect only the information-reporting requirements and do not alter the substantive tax rules that apply to redemptions. Therefore, a corporate shareholder redeeming floating NAV MMFs shares must still recognize and pay tax on gains and losses realized in a redemption. Accordingly, treasury management systems will require modifications to accommodate a floating NAV investment, but such IT projects of necessity often must be prioritized behind revenue- and profit-enhancing efforts key to the long-term success of the business. The planning and implementation of the extensive changes required of treasury management systems that are often part of enterprise-wide information systems can take many months.

S. 1802 would allow fund managers, subject to certain conditions, to offer an institutional prime MMF using amortized cost or penny rounding. This would allow for a stable or constant net asset value, which is so critical to corporate treasurers in their cash management practices. This would fortify the existence of prime MMFs that also are a key component to efficient and affordable short-term financing for many companies, providing working capital to manage the day-to-day fluctuations in their cash balances.

Sincerely,

Thomas C. Deas, Jr.
Chairman

cc: Senator Pat Toomey
Senator Joe Manchin
Senator Bob Menendez

LETTER FROM MICHAEL FRERICHS, ILLINOIS STATE TREASURER, SUBMITTED BY CHAIRMAN CRAPO

OFFICE OF THE ILLINOIS STATE TREASURER
MICHAEL W. FRERICHS

May 17th, 2016

Dear Senator Crapo,

I am writing to lend my support to my colleague from Idaho, Treasurer Ron Crane. In Illinois, our Local Government Investment Pools (LGIPs) are not subject to a floating NAV thanks to a favorable ruling from the Government Accounting Standards Board. However, stable value prime money market funds remain an important cash management tools for state and local governments. That access should be preserved, which is why I share Treasurer Crane's support for S. 1802.

I would appreciate your adding this statement to the Hearing record.

Thank you,

Michael Frerichs

Michael Frerichs
Illinois State Treasurer

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LETTER FROM TOM SALOMONE, 2016 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®, SUBMITTED BY CHAIRMAN CRAPO

NATIONAL ASSOCIATION of REALTORS®

Tom Salomone
2016 President

Dale A. Stinton
Chief Executive Officer

GOVERNMENT AFFAIRS DIVISION
Jerry Giovaniello, Senior Vice President
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Scott Reiter, Vice President
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May 19, 2016

The Honorable Richard Shelby
Chairman
Senate Banking Committee
2228 Rayburn House Office Building
Washington, DC 20515

The Honorable Sherrod Brown
Ranking Member
Senate Banking Committee
2221 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Shelby and Ranking Member Brown:

On behalf of the over 1.1 million members of the National Association of REALTORS® (NAR) and its commercial affiliates, the CCIM Institute, the Institute of Real Estate Management (IREM), the Society of Industrial and Office REALTORS® (SIOR), and the REALTORS® Land Institute (RLI), thank you for holding today's hearing, "Improving Communities' and Businesses' Access to Capital and Economic Development," and for discussing H.R. 4620, the "Preserving Access to CRE Capital Act," sponsored by Representative French Hill (R-AR). NAR supports H.R. 4620, which will provide important, common-sense relief from the overly-broad commercial real estate risk retention rules when they go into effect in December 2016.

The Preserving Access to CRE Capital Act makes a modest but important change to the "Qualified Commercial Real Estate" (QCRE) exemption to the commercial real estate risk retention rules slated to go into effect in December 2016. These impending rules are, as written, overly broad. Single asset/single borrower (SASB) commercial mortgage backed securities (CMBS) are not exempt, despite being low-risk, and not the type of transaction the Dodd-Frank Act was intended to regulate. Rep. Hill's legislation would fix this oversight by widening the QCRE exemption to include SASB and interest-only loans. Without this fix, liquidity rates will be impaired and borrowing costs will go up.

CMBSs are important sources of financing for commercial real estate projects of all kinds, providing about 25% of all commercial real estate lending in the country[1]. They are especially important in secondary and tertiary markets, where they provide a significant portion of the financing for smaller, "Main Street" businesses. Arbitrarily reducing liquidity in the CMBS market will thus reduce liquidity across the board and raise borrowing costs for commercial real estate loans in all markets.

NAR's membership includes nearly 80,000 Commercial REALTORS® and twenty-nine commercial boards throughout the country. The majority of NAR's commercial members work in secondary and tertiary markets, with a median deal of $2.9 million[2]. If the risk retention rules are implemented as written, they will cause a ripple effect of decreased liquidity and raised borrowing costs throughout the commercial real estate market, which will in turn negatively affect our members and the communities they work in.

Thank you again for addressing this important issue for the health of the commercial real estate market. NAR supports H.R. 4620, and looks forward to continuing to work with you on this in the future.

Sincerely,

Tom Salomone
2016 President, National Association of REALTORS®

cc: Senate Banking Committee

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[1] Written Testimony of the Commercial Real Estate Finance Council, http://financialservices.house.gov/uploadedfiles/hhrg-114-ba16-wstate-secrena-20160224.pdf, February 24, 2016

[2] "National Association of REALTORS® Commercial Member Profile 2015." The National Association of REALTORS® https://www.scribd.com/doc/268728286/The-2015-NATIONAL-ASSOCIATION-OF-REALTORS-Commercial-Member-Profile (June 15, 2015)

LETTER FROM JIM BAKER, DEPUTY DIRECTOR OF RESEARCH, UNITE HERE, SUBMITTED BY CHAIRMAN CRAPO

UNITE HERE!

Contact:
Jim Baker
Deputy Director, Research
jbaker@unitehere.org
312-933-0230

U.S. Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment

Improving Communities' and Businesses' Access to Capital and Economic Development

May 19, 2016

Statement for the Record

Good morning. My name is Jim Baker, Deputy Director of Research with UNITE HERE, the union of hotel and hospitality employees throughout North America.

Many of our nearly 300,000 members work for small and medium-sized businesses. To grow and maintain and create jobs for UNITE HERE members and other American workers, small and medium sized businesses in the hospitality industry need access to credit.

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] It is my understanding that the U.S. Senate may soon consider similar legislation.

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]

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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.

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.

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[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.

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.

Thank you.

Jim Baker, Deputy Director of Research
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STATEMENT FROM THE MORTGAGE BANKERS ASSOCIATION, SUBMITTED BY CHAIRMAN CRAPO

MBa

MORTGAGE BANKERS ASSOCIATION

MBA Statement for the Record for the Hearing on "Improving Communities and Businesses Access to Capital and Economic Development"
May 19, 2016

The Mortgage Bankers Association[1] (MBA) appreciates the opportunity to submit this statement for the record regarding the Subcommittee on Securities, Insurance, and Investment hearing entitled, "Improving Communities and Businesses Access to Capital and Economic Development"" (Hearing). MBA commends Chairman Mike Crapo and Ranking Member Mark Warner for holding this important hearing to address the vital concern of business access to capital. Our comments will address impediments to the commercial real estate securitization market and our recommendations for addressing these concerns.

With nearly $3 trillion in commercial real estate debt outstanding, the commercial real estate finance sector is a significant contributor to the U.S. economy. We remain concerned that the cumulative impact of numerous new and enhanced regulatory regimes will not only negatively impact the commercial real estate finance industry, but potentially have a broader chilling effect on the overall economy.

MBA also notes that because of the large number of recently implemented (or about to be implemented) regulatory regimes impacting the commercial real estate securitization market, lenders are required to navigate a maze of often redundant and sometimes conflicting regulations. Our primary concern is that the added regulatory burden on commercial real estate lenders will potentially result in diminished capital availability and increased borrowing costs. During this rapidly evolving regulatory environment, MBA has worked closely with policy makers to inform them on important commercial real estate finance legislative and regulatory matters. While the commercial real estate finance market is impacted by a broad array of new

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

regulations, our comments will focus on the elements of the Dodd-Frank Act that pose significant challenges to this industry.

H.R. 4620, The Preserving Access to CRE Capital Act

MBA supports H.R. 4620, the Preserving Access to CRE Capital Act, because it addresses many of our concerns with the regulatory implementation of the Dodd-Frank risk retention rules and we strongly encourage the Senate to pass similar legislation. Specifically, the bill would provide for:

1. An exemption from risk retention for single property, single borrower commercial real estate loans.
2. For other commercial real estate loans, qualification parameters for risk retention exceptions that better reflect customary and prudent lending practices.
3. In addition to the pari passu structure provided for in the final risk retention rule, allowance of a senior/subordinate structure when there are two third-party risk retention purchasers.

On March 2, 2016, H.R. 4620 was reported out of the House Financial Services Committee by a bipartisan 39-18 vote.

The Risk Retention Final Rule Too Narrowly Defines Exempt Commercial Real Estate Loans

The risk retention rules under the Dodd-Frank Act will fundamentally impact the commercial mortgage backed securities (CMBS) market that currently holds more than $500 billion in commercial real estate loans. CMBS is an important source of liquidity for commercial real estate.

MBA remains concerned that the final risk retention rule could potentially hamper the CMBS market because it too narrowly defined the commercial real estate loans that qualify for a risk retention exemption. The Dodd-Frank Act called for an exemption for commercial real estate loans that were "low risk loans," which was subsequently defined in the final rule as "qualifying commercial real estate (CRE) loans." Analysis of the conduit and single asset, single borrower CMBS loan markets indicate that very few CMBS issuances would qualify for this exemption:

- *Conduit Loans* - Only 5.5 percent of current mortgages comprising conduit CMBS would qualify for zero risk retention. This is due primarily to the fact that the market standard 30-year amortization term is not allowed for qualifying CRE loans.

- *Single Borrower and Single Asset Loans* - Only 2 percent of CMBS comprised of single asset and single borrower loans would meet this exemption, which is also primarily due to the market standard 30-year amortization period prohibition. This low CRE loan qualifying rate is in stark contrast with the excellent performance history – 0.2 percent default rate for single asset and single borrower CMBS.

This brings into question whether the regulatory guidance is consistent with legislative intent when the rule so narrowly defines a qualifying CRE loan. The risk retention final rule should be modified to include a broader range of prudently underwritten commercial real estate loans that would be categorized as qualifying CRE loans. MBA supports H.R. 4620 because it addresses this concern, and we would encourage the Senate to take a similar approach when it addresses this issue.

The Risk Retention Final Rule Should Allow Greater Flexibility for Third-Party Purchasers

In the case of CMBS, the Dodd-Frank Act allows a third-party purchaser to assume the risk retention role by purchasing the subordinate horizontal risk retention position, often referred to as the "B piece." As part of the risk retention final rule, up to two purchasers may purchase the horizontal risk retention position provided that they split it on an equal or pari passu basis. In addition to the pari passu option, MBA strongly supports the ability of these purchasers to be able to create a senior/subordinate structure. Such an option will allow existing market participants to make purchases without having to modify investment structures. MBA was pleased that H.R. 4620 provides the option for two third-party risk retention purchasers to create a senior/subordinate structure and we believe the Senate should take a similar approach to address this issue.

The Risk Retention Rules Should Classify Loans Backed by Single-Family Rental Properties as CRE Loans

Single-family rental (SFR) properties have long been a part of the U.S. housing system. As the share of households living in single-family rental properties has grown, so has the investor base. Loans that finance these properties are most naturally considered a part of the commercial real estate lending market, and thus are commercial real estate loans. Because of the recent emergence of the SFR asset-backed securities (ABS) market, the final risk retention rule did not take into consideration SFR ABS. As such, SFR loans do not fit precisely within the technical definitions of either residential or commercial real estate loans at this time. As a result, informal guidance provided by the risk retention regulatory agencies indicated that, while securities backed by SFR loans are not considered RMBS, SFR loans would fall under the standard risk retention category and thus would not be eligible for certain risk retention structures that are available for CMBS. Accordingly, MBA strongly supports a technical clarification that would treat most ABS that are secured by SFR properties as commercial loans.

Conclusion

We thank Chairman Crapo, Ranking Member Warner, and the members of the Subcommittee on Securities, Insurance, and Investment for their collective attention to the commercial real estate market. We are especially grateful to Senator Crapo for his leadership and willingness to potentially address the resulting ambiguities and nuances regarding the treatment of CMBS found within the Dodd-Frank Act during this implementation phase. We look forward to working with this Subcommittee and other Senators to address these impediments to the commercial real estate securitization market.

STATEMENT FROM THE STATE FINANCIAL OFFICERS FOUNDATION, SUBMITTED BY CHAIRMAN CRAPO

State Financial Officers FOUNDATION

LOOK TO THE STATES

May 17th, 2016

The Honorable Mike Crapo
United States Senator
U.S. Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Securities, Insurance, and Investment
239 Dirksen Senate Office Bldg.
Washington, DC 20510

Dear Chairman Crapo:

We appreciate your conducting the Hearing planned for Thursday, May 19, entitled "Improving Communities and Businesses Access to Capital and Economic Development", at which Idaho Treasurer Ron Crane will testify in support of S. 1802, "The Consumer Financial Choice and Capital Markets Protection Act of 2015".

Treasurer Crane is a valued member of the State Financial Officers Foundation (SFOF), and SFOF supports Treasurer Crane's testimony. I offer the enclosed statement for the hearing, and would greatly appreciate your including it in the hearing record.

Thank you for your co-sponsorship of S. 1802, your leadership of the Subcommittee, and your service and work in the U.S. Senate to preserve and strengthen our capital markets.

Best Regards,

Derek Kreifels, President
State Financial Officers Foundation

P.O. Box 9584 | Mission, KS 66201 | (866) 816-0873 | www.statefinancialofficers.com

Statement of the State Financial Officers Foundation

Submitted to the

U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT

For

HEARING ON IMPROVING COMMUNITIES' AND BUSINESSES' ACCESS TO CAPITAL AND ECONOMIC DEVELOPMENT

Submitted by

DEREK KREIFELS, PRESIDENT OF THE STATE FINANCIAL OFFICERS FOUNDATION

May 19, 2016

We appreciate the opportunity to submit this Statement for the Subcommittee's Hearing to explore improving communities' and businesses' access to capital and economic development. The State Financial Officers Foundation ("SFOF") supports the remarks of The Honorable Ron G. Crane, Idaho State Treasurer, and Treasurer Crane's Statement.[1] We make this Statement to reiterate both (1) the importance of the efficient access to capital markets' funding provided to state and local government, as well as the business community, by money market funds; and (2) the need for the nongovernment money market fund as a simple, convenient and safe tool for SFOF members, and all state and local government finance officials, to prudently seek and obtain the highest market returns on cash in their management of public money.

We support policies that build strong, growing and liquid capital markets. We seek an entrepreneurial and competitive financial services industry that, along with healthy and efficient capital markets, rewards conservative, fiscally responsible public management with the freedom to make borrowing and investment choices among

[1] SFOF is a 501(c)(3) non-partisan organization which operates to promote free market and free enterprise principles and educate the public on the vital role state financial officers play in the operation of state government.

financial instruments, products and services that provide the lowest possible borrowing costs and highest available market returns in the management of public funds.

About SFOF.

SFOF provides a select group of state financial leaders a forum to partner with each other, and the private sector and academia, to develop, implement and promote conservative, fiscally responsible ("pro-growth") public policy. Although united in purpose, and sharing many challenges and opportunities, SFOF financial officers span the nation, geographically, in states from north to south and east to west; from heavily to sparsely populated; from low growth to high growth economies; and range in every other dimension.

In addition to Idaho Treasurer Crane, SFOF membership includes the highest financial officers of Arizona, Arkansas, Colorado, Florida, Georgia, Indiana, Kansas, Kentucky, Maine, Mississippi, Nebraska, Nevada, North Dakota, Ohio, South Carolina, South Dakota and Wyoming.

Money Market Funds provide critical, low-cost funding to state and local government.

Whether viewed in terms of the absolute dollar amounts, or on a per capita basis, the funding presently being provided directly to state and local government, as well as to other non-government, community organizations through the issuance of tax-exempt debt purchased by tax-exempt money market funds, is substantial.

The key point is that all of state and local government, regardless of size, will be seriously impacted and hurt by the loss of efficient, low cost financing from money market funds. The following table provides a breakdown of the aggregate amount, as of December 31, 2015, for the states of SFOF financial officers.

Figure 1.
Funding from Tax-Exempt Money Market Fund Assets of States Represented in SFOF.[2]

State	Funding from TE MMFs ($M)	Population	Per Capita ($)
Arizona	1,945	6,828,065	285
Arkansas	122	2,978,204	41
Colorado	3,653	5,456,574	670
Florida	8,174	20,271,272	403
Georgia	3,517	10,214,860	344
Idaho	605	1,654,930	366
Indiana	4,490	6,619,680	678
Kansas	715	2,911,641	246
Kentucky	1,411	4,425,092	319
Maine	263	1,329,328	198
Mississippi	2,168	2,992,333	725
Nebraska	1,017	2,992,333	536
Nevada	2,693	2,890,845	932
North Dakota	473	756,927	626
Ohio	4,288	11,613,423	376
South Carolina	1,655	4,896,146	338
South Dakota	325	858,469	379
Wyoming	600	586,107	1,023
Total	**38,114**	**90,276,229**	**422**

[2] Source: Crane Data, U.S. Census Bureau

Figure 2.

Funding from Tax-Exempt Money Market Fund Assets

of States Represented by

Members of the Senate Banking Securities Subcommittee[3]

State	Funding from TE MMFs ($M)	Population	Per Capita ($)
Idaho	605	1,654,930	366
Illinois	8,439	12,859,995	656
Indiana	4,490	6,619,680	678
Kansas	715	2,911,641	246
Louisiana	2,705	4,670,724	579
Massachusetts	10,109	6,794,422	1,488
Montana	152	1,032,949	148
Nebraska	1,017	2,992,333	536
Nevada	2,693	2,890,845	932
New Jersey	5,888	8,958,013	657
New York	39,837	19,795,791	2,012
Pennsylvania	6,593	12,802,503	515
Rhode Island	455	1,056,298	431
Tennessee	2,779	6,600,299	421
Virginia	2,891	8,382,993	345
Total	**89,368**	**100,023,416**	**894**

We believe, along with Treasurer Crane, that the record is extensive and clear that most cash investors do not want, and will not use, a floating net asset value ("NAV") for cash investments. Without "non-natural person" investors in stable NAV money market funds, the assets available for funding of state and local government, and businesses, will substantially diminish.

[3] Source: Crane Data. U.S. Census Bureau

Money Market Funds are a critical cash management tool for state and local government.

For more than four decades, money market funds have been used for investment and cash management by millions of investors – individuals, businesses, and governments – who have relied upon them for liquidity, stability, efficiency, and returns.

Therefore, it is difficult to understand why the Securities and Exchange Commission ("SEC") acted to, in effect, completely bar any "non-natural person" investor from the stable value prime money market fund, as well as from the stable value tax-exempt money market fund. As just illustrated for tax-exempt funds, the impact of the outflows from tax-exempt will shrink the market for municipal debt and raise borrowing costs for government and community issuers. Indeed, the repercussions of this rule change are already being felt.

This means that, at the same time that borrowing costs for state and local government are increasing, government is also impacted by yields on cash going down. By banning state and local government investors from using stable value prime money market funds for cash management, we are deprived of a simple, convenient and effective tool for achieving higher yields on cash. We will be required to instead use government money market funds, bank deposits, invest directly in individual securities, or invest in less transparent, less regulated alternative cash management vehicles to the extent permissible under state law.

The utility of the money market fund for cash management – the stable share price – is based on its use of amortized cost accounting to offer investors a stable net asset value ("NAV") or $1 price per share – which a money fund may offer only if it abides by strict risk-limiting requirements of SEC rules. Because these funds are restricted to investing in high-quality, short-term investments and must hold large amounts of cash to meet redemptions, the difference between their estimated "market-based" value and the stable $1 per share at which they are offered is generally within a hundredth of a penny.

Clearly, the SEC did not decide to prohibit amortized cost valuation for money market funds accepting "non-natural persons" because amortized cost is inappropriate for a money market fund's portfolio holdings. Otherwise, how could the SEC still permit amortized cost to be used for "retail" prime and tax-exempt money market funds, as well as for U.S. government funds? The SEC's decision to disallow amortized cost was based on the type of investor in the fund, which, of course, has nothing to do with the value of a fund's holdings.

Then, after the SEC's 2014 rule changes, the Governmental Accounting Standards Board ("GASB")[4] chose to act to continue to permit stable NAV structures, amortized cost valuation, and penny rounding by local government investment pools (" LGIPs") for local government investments (with aggregate assets of $200 billion at 2011) notwithstanding the SEC's new floating NAV requirement.[5] Thus, state Treasurers are in the anomalous position of being able to offer a stable value LGIP to their local government constituents; but not, themselves, to invest in a prime money market fund.

As Treasurer Crane indicates, virtually all units and agencies of state and local government continue to rely, to a significant extent, on money market funds for cash management in addition to using a state-sponsored LGIP, if available. We would add that not all states, for various reasons, sponsor and offer LGIPs. Without the ability to use either an LGIP or a prime money market fund for cash management, local governments in those states are left with no ability to access prime money market instruments through a pooled investment vehicle.

[4] GASB sets accounting standards for state and local governments. GASB shares office location with the Financial Accounting Standards Board, which sets U.S. generally accepted accounting principles ("GAAP").

[5] iMoney, December 2011.

Conclusion.

In conclusion, we believe all can agree that money market funds have been a safe and sound investment for institutional and individual investors and "that MMFs historically have been a paragon of stability" (Comments of Fund Democracy and the Consumer Federation of America to the SEC (Sept. 8, 2009))[6]. This is largely a result of prudent regulation: the successful product of decades of cautious oversight by SEC over the development of a safe and reliable means for investors to obtain market rates of return on their cash investments through the application of very conservative rules for money market fund's structure, operations and assets.

There is no justification for impairing such a critical element of the U.S. financial system. The SEC's new requirement, to impose a floating NAV on "non-natural person" investors, will have the effects of both eliminating a substantial portion of the short-term, capital markets financing and impairing the ability to maximize investment returns on invested cash for state and local government finance officers.

[6] Available at http://www.sec.gov/comments/s7-11-09/s71109-79.pdf

LETTER FROM J. CHRISTIAN BOLLWAGE, MAYOR, CITY OF ELIZABETH, NEW JERSEY, SUBMITTED BY SENATOR MENENDEZ

Office Of The Mayor

CITY OF ELIZABETH, NEW JERSEY

J. CHRISTIAN BOLLWAGE
Mayor

CITY HALL
50 WINFIELD SCOTT PLAZA
ELIZABETH, NEW JERSEY 07201-2462

TEL 908-820-4170
FAX 908-820-0130

November 5, 2015

Honorable Cory Booker
United States Senator
Gateway One
11-43 Raymond Plaza - West Suite 2300
Newark, NJ 07102

Re: S.1802 Consumer Financial Choice and Capital Markets Protection Act of 2015

Dear Senator Booker:

Please let this letter serve as support of S.1802. As you know, this legislation was introduced in the Senate on July 16, 2015 and then referred to the Committee on Banking, Housing and Urban Affairs. I am requesting that you co-sponsor this legislation and help bring it to the Senate floor for a favorable vote.

The City of Elizabeth supports S.1802 because changes made to the structure of money market funds by the Securities and Exchange Commission (SEC) in 2010 and 2014 will substantially impair the ability of local governments to manage cash effectively. The City is particularly concerned with the fact that SEC rule changes in 2014 forced money market funds to abandon their stable $1.00 per-share price and instead utilize a "floating" net asset value (NAV). In addition, the new rules impose penalties and early redemption fees for the pre-mature withdrawal of funds to meet liquidity needs.

Money market funds are a vital cash management tool for local governments, which until the SEC's untimely rule changes, relied on the stability of managing cash with a consistent principal value. Moreover, local governments counted on the convenience and simplicity that a stable NAV provided for accounting, recordkeeping and the tax treatment of cash balances accordingly.

Thank you for your time and consideration.

Sincerely,

J. Christian Bollwage
Mayor

cc: Senator Robert Menendez
Senator Richard Shelby, Chairman, Committee on Banking Housing & Urban Affairs
Senator Pat Toomey, sponsor S.1802

LETTER FROM JOSEPH N. DIVINCENZO, JR., ESSEX COUNTY EXECUTIVE, SUBMITTED BY SENATOR MENENDEZ

3-2-15

OFFICE OF THE COUNTY EXECUTIVE

Hall of Records, Room 405, Newark, New Jersey 07102
973.621.4400 --- 973.621.6343 (Fax)
www.essexcountynj.org

Joseph N. DiVincenzo, Jr.
Essex County Executive

February 25, 2015

Hon. Robert J. Menendez
Senator
One Gateway Center
11th Floor
Newark, NJ 07102

Dear Senator Menendez:

As you know, the Securities and Exchange Commission (SEC) made significant changes to money market mutual funds that will seriously impair our ability to both manage our cash reserves and obtain low-cost financing for important priorities such as schools, hospitals, public transportation and infrastructure projects and services. As a former Mayor, you understand the financial challenges New Jersey counties and municipalities face and why it is critical that we have access to simple, efficient and low-cost professional cash management.

Money market funds are a critical cash management tool for us, whether we use the New Jersey CLASS, other similar pools, or the funds offered through banks or other providers. Money market funds are also the largest purchasers of short-term municipal debt and provide more than two-thirds of the short-term funding for vital local projects and services. The SEC's changes requiring prime and municipal money market funds to maintain a fluctuating share price, while not affecting government funds, endanger the ability to form and run viable Local Government Investment pools and will negatively impact the capital markets leading to higher borrowing costs. As a result of the SEC's changes, the WSJ recently published an article about as institutional money is flowing out of prime funds and into Government funds, the increase in demand for U.S. government securities will continue to depress the yield of those securities for other investors, including state and local governments.

By making it more expensive and difficult to meet short-term borrowing costs, the SEC's changes place additional stress on municipal budgets. For all of these reasons, the New Jersey Association of Counties, the New Jersey League of Municipalities, and the New Jersey Chamber of Commerce filed comment letters strongly opposing the SEC changes. State and local government investors met with the SEC Commissioners, wrote comment letters, and testified at Congressional hearings in opposition to the fluctuating share price. Still, the SEC acted to draw and arbitrary distinction between "retail" and "institutional" investors. Given the strong opposition by investors, state and local governments, and Members of Congress, I urge you to work with your colleagues in the Congress to consider legislative remedies that would preserve the daily liquidity and stable $1 share price for investors.

Sincerely,

Joseph N. DiVincenzo Jr.
Essex County Executive

Putting Essex County First

ESSEX COUNTY IS AN EQUAL OPPORTUNITY EMPLOYER

LETTER FROM JOHN G. DONNADIO, EXECUTIVE DIRECTOR, NEW JERSEY ASSOCIATION OF COUNTIES, SUBMITTED BY SENATOR MENENDEZ

NEW JERSEY ASSOCIATION OF COUNTIES

County Government with a Unified Voice!

Ann M. Cannon
NJAC President
Mercer County Freeholder

John G. Donnadio
Executive Director

February 26, 2015

Honorable Robert Menendez
United State Senator
528 Senate Hart Office Building
Washington, DC 20510

RE: MONEY MARKET FUNDS

Dear Senator Menendez:

On behalf of the Board of Directors of the New Jersey Association of Counties (NJAC), I would like the opportunity to meet with you in person to discuss the recent changes made by the Securities and Exchange Commission (SEC) to the structure of money market funds that will substantially impair county governments' ability to manage cash reserves and obtain low-cost financing for critical infrastructure projects.

NJAC is particularly concerned with the fact that SEC rule changes in 2014 forced money market funds to abandon their stable $1.00 per-share price and instead "float" net asset values (NAV). NJAC is also concerned that the new rules impose penalties and early redemption fees for the pre-mature withdrawal of funds to meet liquidity needs. As you know, money market funds have proven to be a vital cash management tool for county governments, which until the SEC's untimely rule changes, relied on the stability of managing cash with a consistent principal value. Moreover, county governments counted on the convenience and simplicity that a stable NAV provided for accounting, recordkeeping, and the tax treatment of cash balances accordingly.

The dangers of a floating NAV are clear and will undoubtedly lead to increase costs for county governments across New Jersey and the nation. As you also know, money market funds hold more than half of the short-term debt that finances vital public projects such as roads, bridges, airports, water and sewage treatment facilities, hospitals, and low-income housing. Without such financing, local governments may be forced to limit projects, spend more on financing, or increase taxes. Moreover, a floating NAV will force county governments to use bank products that have historically paid lower yields or are much less secure. A floating NAV will also undermine local economies as money market funds hold more than one-third of the commercial paper that businesses use to finance payrolls and inventories. The flight of investors in the wake of a floating NAV will disrupt the supply of short-term credit that employers need to operate.

With this in mind, I look forward to the opportunity of meeting you in person to further discuss the long-term ramifications of a floating NAV and on how we may work together on reinstituting stability and consistency in money market funds. NJAC is committed to advocating for legislation, regulations, and policy directives that empower county governments to operate more effectively and efficiently. As a non-partisan organization that represents the only true regional form of government in the State with a unified and proactive voice, NJAC is dedicated to advancing innovative programs and initiatives that enhance the level of service provided and save valuable taxpayer dollar. Thank you for your time and consideration, and please do not hesitate to contact me at (609) 394-3467 with any questions or concerns.

Very truly yours,

J Donnadio

John G. Donnadio, Esq.
Executive Director

cc: Matthew Chase, Executive Director, National Association of Counties

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LETTER FROM ABRAHAM ANTUN, COUNTY ADMINISTRATOR, HUDSON COUNTY, NEW JERSEY, SUBMITTED BY SENATOR MENENDEZ

COUNTY OF HUDSON
OFFICE OF THE COUNTY ADMINISTRATOR
ADMINISTRATION ANNEX
567 PAVONIA AVENUE
JERSEY CITY, NEW JERSEY 07306

THOMAS A. DE GISE
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ABRAHAM ANTUN
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February 23, 2015

Senator Robert Menendez
528 HSOB
Second Street & Constitution Ave, NE
Washington, DC 20510

Dear Senator Menendez:

As you know, the Securities and Exchange Commission (SEC) made significant changes in 2014 to money market mutual funds that will seriously impair our ability to both manage our cash reserves and obtain low-cost financing for important priorities such as schools, hospitals, public transportation and infrastructure projects. As a former Mayor, you understand the financial challenges New Jersey counties and municipalities face and why it is critical that we have access to simple, efficient and low-cost professional cash management.

Money market funds are a critical cash management tool for us, whether we use the New Jersey Asset & Rebate Management Program or other similar pools offered through banks or other providers. Many New Jersey local units also use the State's Cash Management Fund, a Local Government Investment Pool that while unregulated by the SEC, is subject to the GASB rules and the new SEC regulations will have an adverse impact on these funds as well.

Money market funds are the largest purchasers of short-term municipal debt and provide more than two-thirds of the short-term funding for vital local projects and services. The SEC's changes requiring prime and municipal money market funds to maintain a fluctuating share price, while not affecting government funds, endanger the ability to form and run viable Local Government Investment pools and will negatively impact the capital markets leading to higher borrowing costs. As a result of the SEC's changes, the Wall Street Journal recently published an article about how institutional money is flowing out of prime funds and into Government funds, and that the increase in demand for U.S. government securities will continue to depress the yield of those securities for other investors, including state and local governments. The SEC's changes are a disproportionate reaction to the risk it is trying to prevent, conditions that might only exist in the face of a future fiscal crisis.

By making it more expensive and difficult to meet short-term borrowing costs, the SEC's changes place additional stress on county, municipal, and local authority budgets. For all of these reasons, we support the comment letters of the Government Finance Officers Association, New Jersey Association of Counties, the New Jersey League of Municipalities, and the New Jersey Chamber of Commerce, along with their national counterpart organizations that strongly oppose the SEC changes. State and local government investors met with the SEC Commissioners, wrote comment letters, and testified at Congressional hearings in opposition to the fluctuating share price. Still, the SEC acted to draw an arbitrary distinction between "retail" and "institutional" investors.

Given the strong opposition by investors, state and local governments, and Members of Congress, I urge you to work with your colleagues in the Congress to consider legislative remedies that would preserve the daily liquidity and stable $1 net asset value share price for investors and eliminate the requirement to charge penalty and early redemption fees for pre-mature withdrawal of funds to meet liquidity needs of the local unit.

Sincerely,

Abraham Antun