TPG SPECIALTY LENDING[SM]

# A Path to a More Sustainable Neighborhood

## Response to SEC Request for Comments on Proposed Rule 12d1-4

May 2019

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# Structural Impediments to Effective Governance in the BDC Sector

AFFE Rule + "3% Rule" + 40 Act Voting and Quorum Requirements

Unintended consequences of limiting institutional ownership(1)

Ownership and voting limitations silence certain shareholder voices

High quorum requirements coupled with limited institutional ownership constrain effectiveness of shareholder rights(2)

**Erosion of Investor Protection**

These structural impediments combine to facilitate an entrenchment of many severely underperforming external advisers in the BDC sector

*(1) Please see appendix for more information.*
*(2) Shareholder termination of an existing management contract under the Investment Company Act requires the affirmative vote of the lesser of (i) the holders of a majority of the outstanding shares, and (ii) 67% of the votes cast, if holders of at least a majority of the outstanding shares are present in person or by proxy at such meeting.*

# Proposed Rule 12d1-4

1 Background

2 Our Proposed Amendments

3 Practical Implications of Ownership and Voting Limitations

## Existing Framework

- In 2006, the Securities and Exchange Commission (the "SEC") adopted three new rules, 12d1-1, 12d1-2 and 12d1-3 under the Investment Company Act of 1940 (the "1940 Act").
- Section 12(d)(1) was designed to increase investor protection by preventing one fund from exerting undue influence and detrimental control over the regulated funds it acquired and to **prevent fee layering relating to fund "pyramiding" arrangements.**
- Specifically, Section 12(d)(1)(A) places these limits on registered investment companies (or "acquiring funds") from:
  1) Owning more than **3%** of another registered fund's outstanding voting securities;
  2) Investing more than **5%** of the fund's total assets in another registered fund; and
  3) Investing more than **10%** of the fund's total assets in other registered funds in the aggregate.
- In addition, Section 12(d)(1)(C) limits a registered investment company and other funds advised by the same adviser from owning more than **10%** of another regulated fund's voting securities.

# Proposed Rule 12d1-4

1 Background

2 Our Proposed Amendments

3 Practical Implications of Ownership and Voting Limitations

## Highlights

- On December 19, 2018, the SEC proposed a new rule 12d1-4 (the "Proposed Rule").
- The Proposed Rule, amongst other changes, calls for a change to:
  - **Ownership limits**: can exceed the 3%/5%/10% limits imposed by Section 12(d)(1) of the 1940 Act without obtaining an exemptive order from the SEC, subject to certain conditions.
  - **Control and voting:** prohibit an acquiring fund from controlling an acquired fund and would require an acquiring fund that holds more than 3% of an acquired fund's outstanding voting securities to:
    - Seek voting instructions from its security holders and vote such proxies in accordance with their instructions (pass-through voting), or
    - Vote the share in the same proportion as the vote of all other holders of the acquired fund (mirror voting).

The practical burden of seeking pass-through voting instructions under the Proposed Rule continue to create an effective 3% voting limit

# Proposed Rule 12d1-4

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## Price of an Equity Security

- We believe the 3% voting limitation under the Proposed Rule would limit the desirability for acquiring funds to hold more than 3% of the voting stock of an acquired fund.
- The price of an equity security reflects the i) economic value, plus the ii) value of governance (which includes the ability to vote in certain corporate matters).


- Separating these two components removes the incentive for an investor to acquire additional ownership above the 3% limit at the market value of the equity security.

Disincentive to hold incremental shares above the 3% voting limit

# Considerations for Proposed Amendments to Rule 12d1-4

1 Background

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3 Practical Implications of Ownership and Voting Limitations

## Our Proposed Amendments

We have the following recommendations (in green) to be included in the Proposed Rule:

1 Section 12(d)(1)(A):

- Places limits on registered investment companies (or "acquiring funds") from:

1) Owning more than ~~5%~~ → 10% of another registered fund's outstanding voting securities;

2) Investing more than **5%** of the fund's total assets in another registered fund; *No change*

3) Investing more than **10%** of the fund's total assets in other registered funds in the aggregate. *No change*

2 Section 12(d)(1)(C):

- Limits a registered investment company and other funds advised by the same adviser from owning more than ~~10%~~ → 25% of another regulated fund's voting securities.

*For recommendations 1 & 2, no limit on ability to vote full economic ownership*

We believe our recommendations to the Proposed Rule promote effective governance, along with upholding:

- ✓ investor protections as intended by rule 12d1-4, including preventing acquiring funds from obtaining control over acquired funds*; and
- ✓ policy objectives similar to those included in previously-issued SEC exemptive orders

** Section 2(a)(9) of the 1940 Act presumes "control" of a company upon the ownership of more than 25% of the voting securities of the company.*

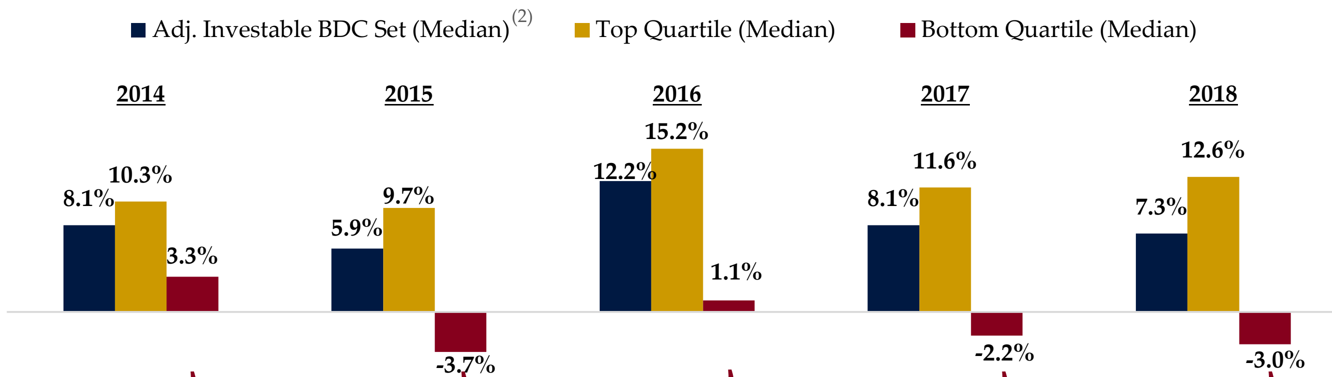
# Incumbency of Underperforming External BDC Advisers

1 Background

2 Our Proposed Amendments

3 Practical Implications of Ownership and Voting Limitations

## BDC Performance – Annual Return on Equity[1]




### BOTTOM QUARTILE BDCS[3]

| 2014 | |
|---|---|
| BDC 8 | 5.0% |
| **BDC 1** | **3.5%** |
| **BDC 2** | **3.3%** |
| BDC 9 | 2.7% |
| **BDC 3** | **-0.6%** |

| 2015 | |
|---|---|
| **BDC 1** | **-1.5%** |
| **BDC 4** | **-1.7%** |
| BDC 10 | -3.7% |
| **BDC 2** | **-5.5%** |
| **BDC 3** | **-13.6%** |

| 2016 | |
|---|---|
| **BDC 5** | **4.1%** |
| **BDC 2** | **3.2%** |
| **BDC 6** | **2.9%** |
| **BDC 4** | **-0.7%** |
| **BDC 1** | **-6.6%** |
| **BDC 7** | **-11.4%** |

| 2017 | |
|---|---|
| **BDC 4** | **5.0%** |
| **BDC 7** | **3.5%** |
| **BDC 5** | **-2.1%** |
| **BDC 6** | **-2.4%** |
| **BDC 2** | **-10.4%** |
| **BDC 1** | **-14.9%** |

| 2018 | |
|---|---|
| **BDC 6** | **1.9%** |
| **BDC 7** | **-1.8%** |
| **BDC 3** | **-2.9%** |
| **BDC 5** | **-3.1%** |
| BDC 11 | -3.8% |
| **BDC 2** | **-21.2%** |

*Shaded names represent BDCs that have been in the bottom quartile three or more times in the last five years*

*Note: Investable BDC Set includes AINV, ARCC, BKCC, CGBD, FDUS, FSK, GAIN, GBDC, GSBD, MCC, NMFC, OCSI, OCSL, OXSQ, PFLT, PNNT, PSEC, SLRC, TCPC, TCRD, TSLX. For the purposes of this analysis, Investable BDC Set consists of 21 externally managed BDCs in the S&P BDC Index with total assets greater than $600 million based on reported financial statements as at June 30, 2017 or June 30, 2018.*
*(1) Return on equity as measured by GAAP net income per share for each calendar year, divided by beginning NAV per share.*
*(2) Adj. Investable BDC Set excludes the bottom quartile BDCs for each calendar year.*
*(3) Bottom quartile BDCs for each year is determined by return on equity.*
*Source: SNL*

The same BDCs underperform year after year with limited governance accountability

# Incumbency of Underperforming External BDC Advisers

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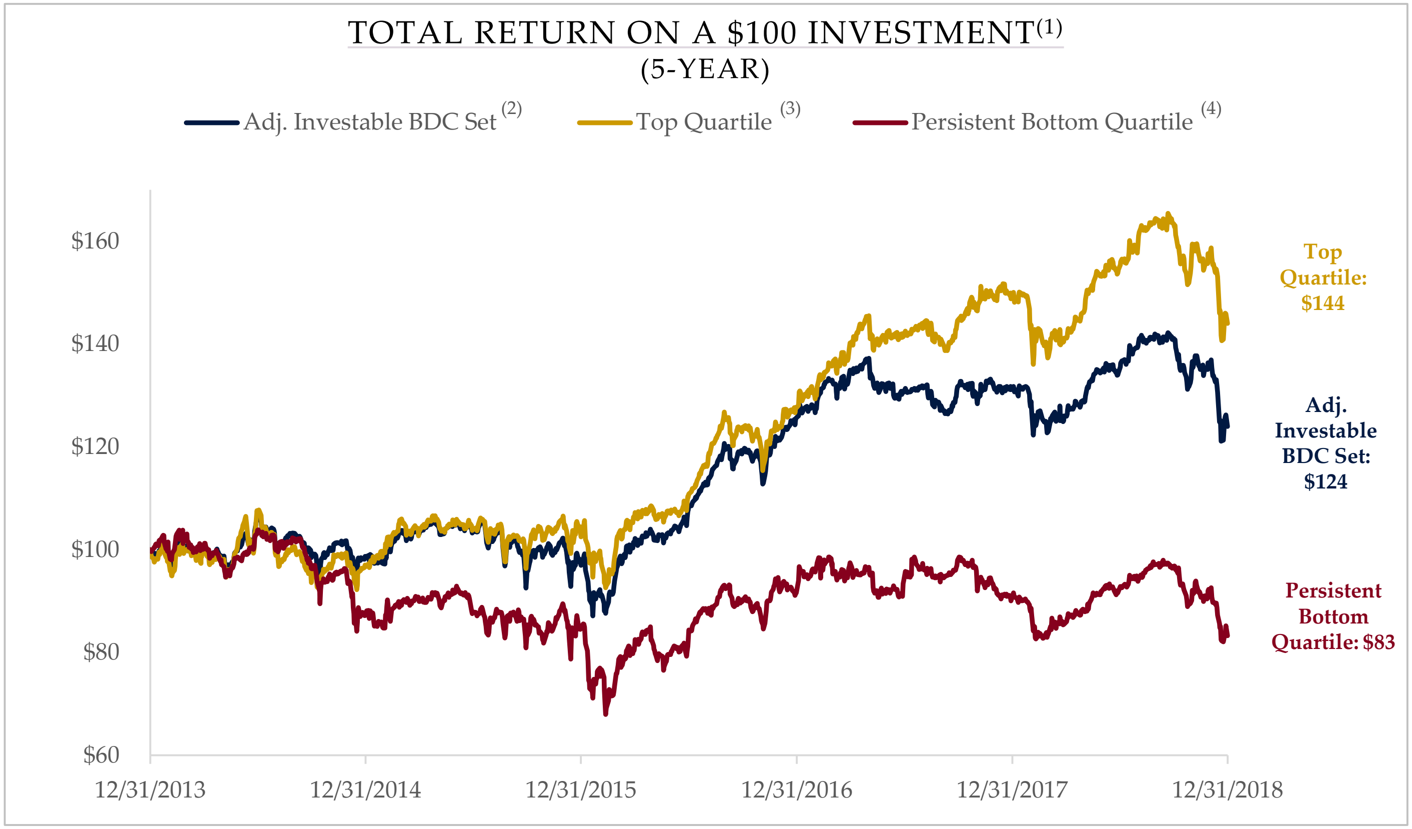
## BDC Stock Performance




*Note: Investable BDC Set includes AINV, ARCC, BKCC, CGBD, FDUS, FSK, GAIN, GBDC, GSBD, MCC, NMFC, OCSI, OCSL, OXSQ, PFLT, PNNT, PSEC, SLRC, TCPC, TCRD, TSLX. For the purposes of this analysis, Investable BDC Set consists of 21 externally managed BDCs in the S&P BDC Index with total assets greater than $600 million based on reported financial statements as at June 30, 2017 or June 30, 2018.*

*(1) Total return represents stock price movement plus dividends; assume dividend reinvestment.*

*(2) Investable BDC Set adjusted to exclude Persistent Bottom Quartile BDCs.*

*(3) Top Quartile BDCs are based on the average annualized return on equity for the historical 5-year period, which is calculated as cumulative net income per share from 12/31/2013 through 12/31/2018 divided by beginning period's NAV per share, adjusted for annual basis.*

*(4) Persistent Bottom Quartile BDCs are those that have appeared in the bottom quartile three or more times in the past five years based on annual return on equity, which is calculated as net income per share for each calendar year, divided by beginning period's NAV per share. See page 8 for more details.*

*Source: SNL*

Over the last 5 years, Persistent Bottom Quartile BDCs' total shareholder returns were 33% less than Adj. Investable BDC Set and 42% less than Top Quartile BDCs

# Incumbency of Underperforming External BDC Advisers

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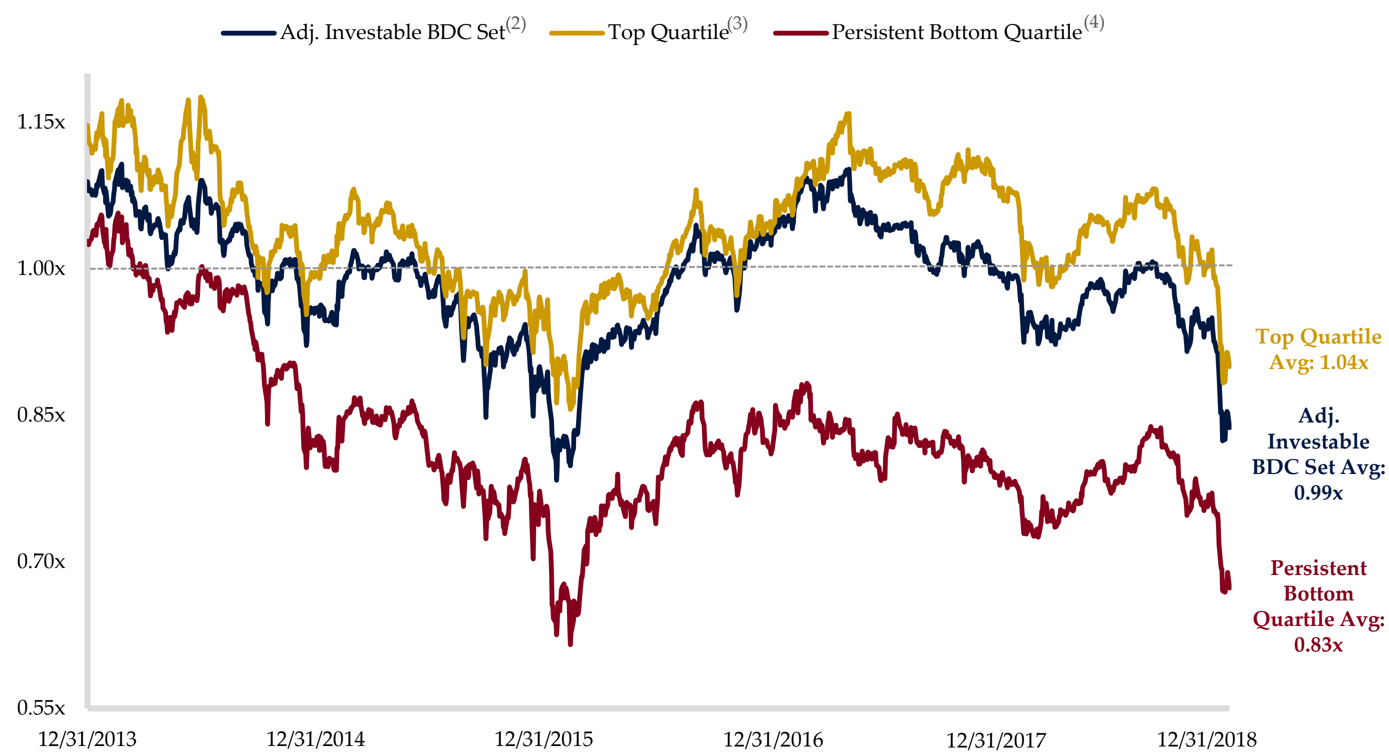
## BDC Price-to-Book Trading Multiples[1]




*Note: Investable BDC Set includes AINV, ARCC, BKCC, CGBD, FDUS, FSK, GAIN, GBDC, GSBD, MCC, NMFC, OCSI, OCSL, OXSQ, PFLT, PNNT, PSEC, SLRC, TCPC, TCRD, TSLX. For the purposes of this analysis, Investable BDC Set consists of 21 externally managed BDCs in the S&P BDC Index with total assets greater than $600 million based on reported financial statements as at June 30, 2017 or June 30, 2018.*

(1) *Based on trading price per share divided by last reported book value per share.*

(2) *Investable BDC Set adjusted to exclude Persistent Bottom Quartile BDCs.*

(3) *Top Quartile BDCs are based on the average annualized return on equity for the historical 5-year period, which is calculated as cumulative net income per share from 12/31/2013 through 12/31/2018 divided by beginning period's NAV per share, adjusted for annual basis.*

(4) *Persistent Bottom Quartile BDCs are those that have appeared in the bottom quartile three or more times in the past five years based on annual return on equity, which is calculated as net income per share for each calendar year, divided by beginning period's NAV per share. See page 8 for more details.*

*Source: SNL*

Over the last 5 years, Persistent Bottom Quartile BDCs' average price-to-book multiples were 16% less than Adj. Investable BDC Set and 20% less than Top Quartile BDCs

# Incumbency of Underperforming External BDC Advisers

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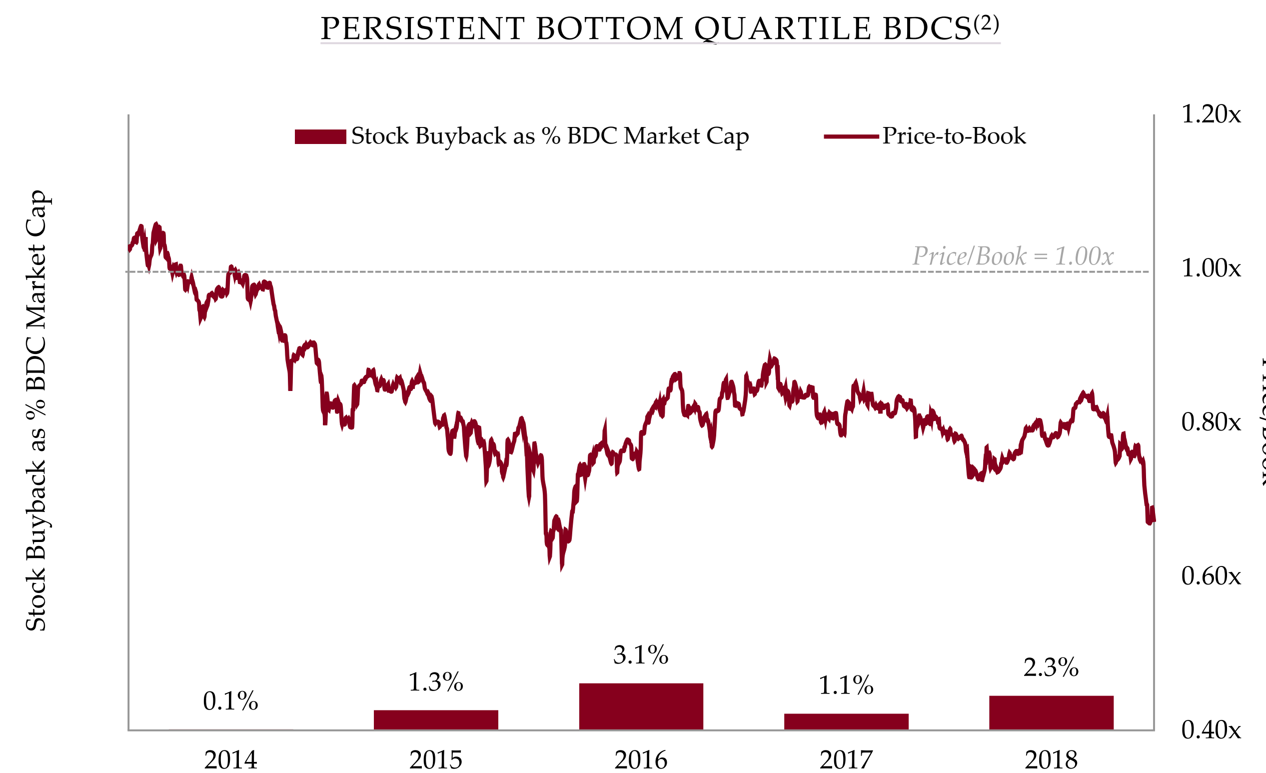
## BDC Stock Buybacks[1]




(1) BDC stock buybacks % calculated as the dollar amount of stock repurchased divided by average BDC market cap in each period.
(2) Analysis based on Investable BDC Set that have appeared in the bottom quartile three or more times in the past five years based on annual return on equity, which is calculated as net income per share for each calendar year, divided by beginning period's NAV per share. See page 8 for more details.
Source: SNL

Persistent BDC underperformers have done de minimis stock buybacks…even when trading at meaningful discount to NAV

# Shareholder Base Profiles and Governance

1 Background

2 Our Proposed Amendments

3 Practical Implications of Ownership and Voting Limitations

*BDC shareholder-driven governance accountability severely lags the broader market*

## Shareholder Initiated Proxy Contests (LTM March 2019)

**Russell 3000 Index**

- There were more than **50** instances of shareholder-initiated proxy contests
- Target companies in this universe have an average number of "3% or more" shareholders of **6.4** (1)

**Investable BDC Set**

- There were **0** instances of shareholder-initiated proxy contests
- For the Investable BDC Set, the average number of shareholders with 3% or greater ownership is **1.8** (2)

*Note: Investable BDC Set includes AINV, ARCC, BKCC, CGBD, FDUS, FSK, GAIN, GBDC, GSBD, MCC, NMFC, OCSI, OCSL, OXSQ, PFLT, PNNT, PSEC, SLRC, TCPC, TCRD, TSLX. For the purposes of this analysis, Investable BDC Set consists of 21 externally managed BDCs in the S&P BDC Index with total assets greater than $600 million based on reported financial statements as at June 30, 2017 or June 30, 2018.*
*(1) Based on 45 ownership holdings as of 12/31/2018 for issuers that continue to be publicly-listed (i.e. holdings data available).*
*(2) Based on ownership holdings as of 12/31/2018.*
*Source: D.F. King, KBW*

Ownership and voting limitations play a notable role in shareholder-led governance reform…

# Dampening of the Effectiveness of Intended Governance Tools

1 Background

2 Our Proposed Amendments

3 Practical Implications of Ownership and Voting Limitations

## BDC Governance Scorecard

| 2014 | | 2015 | | 2016 | | 2017 | | 2018 | |
|---|---|---|---|---|---|---|---|---|---|
| BDC 8 | 5.0% | BDC 1 | -1.5% | BDC 5 | 4.1% | BDC 4 | 5.0% | BDC 6 | 1.9% |
| BDC 1 | 3.5% | BDC 4 | -1.7% | BDC 2 | 3.2% | BDC 7 | 3.5% | BDC 7 | -1.8% |
| BDC 2 | [illegible] | BDC 10 | [illegible] | BDC 6 | 2.9% | [illegible] | -2.1% | [illegible] | -2.9% |
| BDC 9 | 2.7% | [illegible] | -5.5% | BDC 4 | [illegible] | [illegible] | [illegible] | BDC 5 | [illegible] |
| BDC 3 | -0.6% | BDC 3 | -13.6% | BDC 1 | -6.6% | BDC 2 | -10.4% | BDC 11 | -3.8% |
| | | | | BDC 7 | -11.4% | BDC 1 | -14.9% | BDC 2 | -21.2% |

**Firms in the Investable BDC Set that have been in the bottom quartile three or more times in the last five years:**

| | |
|---|---|
| Investment advisory contracts not renewed through annual 15(c) process | *Zero* |
| Successful shareholder-led governance reform | *Zero* |
| Activism-generated consolidation of externally managed BDCs | *Zero* |

…to the detriment of the sector's shareholders

# Considerations for Proposed Amendments to Rule 12d1-4

## Summary

| | |
|---|---|
| Ownership Limits Under Proposed Rule | We support easing the investment limit thresholds under the Proposed Rule because we believe it will be **positive for investor protection** in the registered fund space. |
| Voting Limits Under Proposed Rule | However, we believe voting restrictions under the Proposed Rule would continue to handicap the ability of investors to drive positive change through governance. |
| Our Recommendations | We believe our recommendations, as summarized below…<br>1. Increasing the limit on how much a registered investment company (or "acquiring funds") can own of another registered fund's outstanding voting securities from 3% to 10%; and<br>2. Increasing the limit on how much a registered investment company and other funds advised by the same adviser can own of another regulated fund's voting securities from 10% to 25%.<br>…each with no limitation on ability to vote full economic ownership, can mitigate the adverse governance implications under the proposed voting restrictions while continuing to offer the investor protections as originally intended by Section 12(d)(1) by staying within the "control" ownership thresholds under the 1940 Act. |

# Considerations for Proposed Amendments to Rule 12d1-4

## Benefits of Our Recommendations for Externally-Managed BDC Sector

- ✓ Improved tools for shareholder-led governance reform
- ✓ Enhanced capital allocation
- ✓ Removal of inefficient excess capital
- ✓ A better investor experience

**A more sustainable BDC neighborhood**

# Appendix

# AFFE Rule

| | Overview |
|---|---|
| **What It is:** | • The Acquired fund fees and expenses ("AFFE") rule is a SEC prospectus disclosure requirement for SEC regulated funds, including mutual funds that invest in other funds (including BDCs)<br>• The AFFE rule requires disclosure from the "acquiring fund" to:<br>1. Include in the "acquiring fund" expense table a separate line item showing its pro rata share of all the "acquired fund's" (i.e., a BDC's) expenses; and<br>2. Add its pro rata share of "acquired fund's" (i.e., BDC's) expenses to its overall expense ratio<br>• AFFE disclosure requirements have no impact on acquiring fund financial statements or net asset value per share calculation |
| **The "Issue":** | • The AFFE rule's expense ratio disclosure was designed to increase transparency for investors in SEC regulated funds. However, the requirement also fundamentally distorts the acquiring fund's disclosed expense ratio<br>- Effectively double counts the acquired fund's expenses as these "costs" are already incorporated into the net returns received by the acquiring fund<br>- Costs incorporated into the acquiring fund's disclosed expense ratio (e.g. interest expense, management fees) are not additional expenses incurred by investors<br>• Creates the misperception that the acquiring fund's expenses are higher than they actually are and implies that the acquiring fund is engaged in the same operating activities as the acquired fund (i.e., BDC)<br>• In 2014, S&P and Russell each announced that BDCs would be ineligible for index inclusion citing concerns regarding AFFE reporting |
| **Unintended Consequences on BDCs(1):** | • The impact on BDCs has been disproportionately negative through:<br>✘ Reduced institutional ownership – less professional investor pressure on governance/oversight<br>✘ Decline in BDC market depth and liquidity<br>✘ Less independent third-party research coverage<br>**Erosion of Investor Protection** |

*(1) Refer to SBIA comments on the Proposed Rule regarding Fund of Funds Arrangements submitted to the SEC on April 30, 2019.*

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