



An Alternative for Private Equity: BDCs

As we all know, the credit crisis has shut off classic sources of funding for many small businesses. However we know that for every action there is an equal and opposite reaction. One reaction to the shrinking supply of credit has been the emergence (actually the re-emergence) of business development companies (“BDC”s) as an alternative form of small business finance. Investors are reconsidering BDCs because of the current opportunities to extract more favorable terms from portfolio companies and the resulting attractive risk-adjusted yields.

A BDC is a special investment vehicle designed to facilitate capital formation for small companies. BDCs are exempt from many of the regulatory constraints imposed by the Investment Company Act of 1940 (the “1940 Act”) and the rules thereunder. Section 2(a)(48) of the 1940 Act defines “business development company” to mean a domestic closed-end company that (i) operates for the purpose of making investments in certain securities specified in Section 55(a) of the 1940 Act and, with limited exceptions, makes available “significant managerial assistance” with respect to the issuers of such securities; and (ii) has elected business development company status.¹ A BDC must, as a general matter, maintain at least 70% of its investments in eligible assets before investing in non-eligible assets, and must provide or make available “significant managerial assistance.”

Types of Investments

Pursuant to Section 55(a) of the 1940 Act, a BDC generally must have at least 70% of its total assets in the following investments:

- privately issued securities purchased from issuers that are “eligible portfolio companies”² (or from certain affiliated persons);
- securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director;³
- privately issued securities of companies subject to a bankruptcy proceeding, reorganization, insolvency or similar proceeding or otherwise unable to meet its obligations without material assistance;

¹ To be treated as a BDC, a company must elect, pursuant to Section 54(a) of the 1940 Act, to be subject to the provisions of Sections 55 through 65 of the 1940 Act. The company must file a Form N-6 (intent to file a notification of election) and a Form 54A (election to be regulated as a BDC). A BDC must also file a comprehensive registration statement on Form N-2.

² An eligible portfolio company means a domestic issuer that either (1) does not have any class of securities listed on a national securities exchange; or (2) has a class of equity securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million and, in each case, (A) is not, with limited exceptions, a registered or unregistered investment company; or (B) either: (i) does not have a class of securities that are “margin securities,” (ii) is controlled by a BDC and has an affiliated person of the BDC as a director, or (iii) has total assets of not more than \$4 million, and capital and surplus (shareholders’ equity less retained earnings) of not less than \$2 million, or (3) has a class of securities listed on a national securities exchange.

³ A controlling interest is presumed if the BDC owns more than 25% of a portfolio company’s voting securities.

- cash, cash items, government securities, or high quality debt securities maturing in one year or less; and
- office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business of the BDC.

Significant Managerial Assistance

Unlike typical registered investment companies, BDCs are not passive investors. Rather, a BDC is required to make available “significant managerial assistance” to the companies that it treats as satisfying the 70% standard. This includes any arrangement whereby a BDC, through its directors, officers, employees, or general partners, provides significant guidance and counsel concerning the management, operations, or business objectives and policies of the portfolio company. It may also mean exercising a significant controlling influence over the management or policies of the portfolio company.⁴

Tax Treatment

BDCs typically are organized as limited partnerships in order to obtain pass-through tax treatment. More recently, some BDCs have been organized as corporations and have obtained pass-through tax treatment by meeting the requirements of Subchapter M of the Internal Revenue Code of 1986, as amended, relating to composition of income and diversification of assets. BDCs are typically registered under the Securities Act of 1933 and the Securities Exchange Act of 1934.

Affiliate Transactions

Types of Restricted Transactions

Unlike traditional investment companies, which are subject to the affiliated transaction prohibitions of Section 17 of the 1940 Act, BDCs are subject to Section 57 of the 1940 Act, which is a substantially modified and relaxed version of Section 17. Section 57 generally prohibits a BDC from effecting or participating in transactions involving conflicts of interest unless certain procedures are satisfied. Subsections 57(a) and (d) prohibit certain persons (“affiliates”) from participating in certain transactions involving the BDC and describe four types of transactions (“Restricted Transactions”) that such persons (and certain affiliated persons of those persons), acting as principal, may not enter into with the BDC without prior approval:

- an affiliate may not knowingly sell any securities or other property to the BDC or a company controlled by it, unless either the BDC is the issuer of the securities being sold, or the affiliate is the issuer and the security is part of a general offering to the holders of a class of its securities;
- an affiliate may not knowingly purchase from the BDC or a company controlled by it any security or other property except securities issued by the BDC;
- an affiliate may not knowingly borrow money or other property from the BDC or a company controlled by it, with limited exceptions; and
- an affiliate is prohibited from knowingly effecting any joint transactions with the BDC or a company controlled by it in contravention of SEC rules.

Categories of BDC Affiliates Regulated by Section 57

Affiliates can be grouped into one of the three general categories, which determines the type of approval, if any, required before engaging in a Restricted Transaction. The categories of BDC affiliates are described below.

⁴ If a BDC intends to operate under the Small Business Investment Act of 1958, making loans to a portfolio company would satisfy the “significant managerial assistance” requirement.

First Tier Affiliates: Restricted Transactions with the following “first tier affiliates” of a BDC are prohibited unless the BDC receives prior approval from the SEC:

- any director, officer or employee of the BDC;
- any entity that a director, officer or employee of the BDC controls; or
- a BDC’s investment adviser, promoter, general partner or principal underwriter, or any person that controls or is under common control with such persons or entities or is an officer, director, partner or employee of any such entities.

Second Tier Affiliates: Restricted Transactions with the following “second tier affiliates” are prohibited unless a majority of the directors or general partners who are not interested persons of the BDC (as defined in the 1940 Act) and who have no financial interest in the transaction approve the transaction:

- any 5% shareholder of the BDC, any director or executive officer of, or general partner in, a 5% shareholder of the BDC, or any person controlling, controlled by, or under common control with such 5% shareholder; or
- any affiliated person of a director, officer or employee, investment adviser, principal underwriter for or general partner in, or of any person controlling or under common control with, the BDC.

Controlled Affiliates: A “controlled affiliate” is a downstream affiliate of a BDC whose securities are more than 25% owned by the BDC. A controlled affiliate is treated the same as a second tier affiliate when engaging in Restricted Transactions with the BDC. It is also important to note, however, that the affiliated transaction prohibitions of Section 57 “flow-through” to all controlled affiliates of the BDC. For example, if a BDC owns 30% of Company A, Company A could not purchase securities from a first tier affiliate of the BDC, unless the BDC receives prior SEC approval.

Section 57(h) of the 1940 Act also requires the directors or general partners of the BDC to maintain procedures to monitor the possible involvement of first and second tier affiliates in Restricted Transactions. Attached as Exhibit A is a chart showing various possible affiliates of a BDC and whether such affiliates are first tier, second tier or controlled affiliates. Also attached as Exhibit B following this memorandum is a table that includes a number of examples of affiliated transactions of BDCs, and provides guidance on whether such transactions require SEC approval, board approval or no approval at all. It is not possible to address all potential circumstances in a memorandum such as this. Accordingly, the following discussion and the Exhibits are only intended to illustrate certain circumstances for analysis.

Internal versus External Management Issues

Internal v. External Management

A BDC may be internally or externally managed. In some instances, the officers and directors of internally managed BDCs supervise daily operations. In other instances, an internally managed BDC will establish a wholly-owned subsidiary to conduct daily operations. The officers, directors or wholly-owned subsidiary of an internally managed BDC are not registered with the SEC as investment advisers. Internally managed BDCs generally have lower expense ratios because the BDC pays the operating costs associated with employing investment management professionals as opposed to an investment advisory fee, which includes a profit margin. Internally managed BDCs have fewer conflicts between the interests of the manager and the owners of the BDC. However,

an internally managed BDC must develop the infrastructure and hire employees or establish a subsidiary to manage the BDC and must address issues related to having custody of the portfolio assets.⁵

An externally managed BDC must contract with a third party to provide investment advisory services. An external investment adviser presumably already has the infrastructure, staff and expertise to satisfy the regulatory requirements applicable to BDCs, including issues relating to custody of assets. However, the investment advisory agreement is subject to the requirements of the 1940 Act, which include, among other things, approval by the board of directors and shareholders. Certain inherent conflicts of interest may exist regarding the adviser's allocation of investment opportunities between the BDC and the adviser's other clients. Investment advisers to externally managed BDCs must be registered with the SEC. Therefore, if an adviser previously operated as an unregistered investment adviser, the adviser may be required to register with the SEC before serving as the BDC's investment adviser.⁶

Fees

Section 205(b)(3) of the Advisers Act permits an investment adviser of a BDC to receive performance-based compensation, provided that it does not exceed 20% of the realized capital gains of the BDC, net of realized capital losses and unrealized capital appreciation over a specified time period or as of specified dates. The SEC staff has stated that the 20% limitation is the maximum performance fee, and not the maximum total compensation. Thus, the investment adviser can receive a management fee in addition to the performance fee.

If a BDC elects to pay its investment adviser performance-based compensation, then the BDC cannot maintain an executive compensation plan that would otherwise be permitted under the 1940 Act. Section 61(a)(3)(B) of the 1940 Act permits a BDC to issue to certain directors, officers and employees warrants, options and rights to purchase voting securities of the BDC pursuant to an executive compensation plan if, among other requirements: (i) the issuance is approved by the partners and directors of the BDC (also requires SEC approval if issuance is to a director who is not also an officer or employee of the BDC); (ii) the exercise or conversion price of such warrants, options and rights is no less than the current market value or net asset value of the voting securities; (iii) the voting securities are non-transferable (except by gift, will or intestacy); and (iv) the warrants, options and rights are not separately transferable (unless no class of such warrants, options or rights and the securities accompanying them have been publicly distributed).

Disclosure Requirements

A publicly offered BDC must register its securities on Form N-2. The registration statement must provide enough "essential information" about the BDC so as to help the investor make informed decisions about whether to purchase the securities being offered. Generally, the registration statement must describe, among other things:

- the terms of the offering, including the number of shares being offered, price, underwriting arrangements and compensation;
- intended use of the proceeds;
- investment objectives and policies, including any investment restrictions;
- risk factors associated with investment in the BDC, including special risks associated with investing in a portfolio of small and developing or financially troubled businesses; and

⁵ It should be possible to limit the activities of investment professionals of an internally managed BDC to avoid registration under the Investment Advisers Act of 1940 (the "Advisers Act"). The investment professionals of the few existing internally managed BDCs have not registered.

⁶ Registration as an investment adviser adds another layer of regulatory requirements, including, among other things, adoption of a compliance program, appointment of a chief compliance officer, and adoption of a code of ethics for directors, officers and investment personnel governing personal investing activities.

- management of the BDC, including directors, officers and the investment adviser.

To the extent that a BDC has identified but not yet purchased prospective portfolio companies for its initial offering, the initial registration statement should, at a minimum, describe the general characteristics of the prospective portfolio companies and the BDC's criteria for identifying prospective portfolio companies. The description should include general guidelines used in the investment decision and any key elements of the BDC's investment methodology. If the BDC owns the portfolio company at the time of registration, then, the registration statement must identify each portfolio company and disclose: (1) the nature of the portfolio company's business; (2) title, class, percentage of class, and value of portfolio company securities held by the BDC; (3) amount and general terms of all loans to portfolio companies; and (4) the relationship of the portfolio companies to the BDC.

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