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Proposed Legislation Would Increase Investment Opportunities For Business Development Companies

By Anna T. Pinedo and Jay Baris

The Next Steps for Credit Availability Act (H.R. 5929), introduced by Rep. Michael G. Grimm and Rep. Nydia Velázquez in June 2012, would allow BDCs to invest more of their assets in start-up companies and small- to mid-sized businesses.

Among other things, the bill would:

- Amend the Investment Company Act of 1940 (the "1940 Act") to permit BDCs to own investment adviser subsidiaries. Currently, the 1940 Act prohibits BDCs from investing in wholly owned subsidiaries that are registered investment advisers.
- Increase leverage ratios for BDCs. The bill would reduce the asset coverage requirements to 150 percent from 200 percent. That is, the bill would increase the ability of a BDC to leverage its investments, allowing it to borrow $2 to lend to small businesses for every $3 it holds in assets. Currently, for every $1 it borrows to lend to small businesses, a BDC must hold $2 in assets.
- Allow BDCs to count preferred stock as equity rather than debt, so that they would have more assets available to lend.
- Ease reporting requirements, to put BDCs on par with other companies. Among other things, BDCs that meet the requirements of Form S-3 would be able to incorporate by reference information disclosed in quarterly and annual filings in their registration statement. BDCs must register their shares on Form N-2, which currently does not allow such incorporation by reference.

The stated goal of the proposed legislation is to encourage BDCs to "move quickly when opportunities arise" to take a registration "from the shelf" and offer it to the capital markets, thus allowing BDCs opportunities to invest in small and mid-size businesses that they would otherwise miss.[1]

Background. BDCs are a category of closed-end investment companies that are operated for the purpose of making investments in small and developing businesses and financially troubled businesses. BDCs make available significant managerial assistance to these portfolio companies. BDCs have greater flexibility under the 1940 Act than other investment companies in dealing with their portfolio companies, issuing securities, and compensating their investment advisers. Closed-end companies that elect to be treated as BDCs technically do not have to register as investment companies under the 1940 Act. But BDCs are subject to many of the 1940 Act's restrictions, must register their shares under the Securities Act of 1933 (the "Securities Act"), and are subject to reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act").

[1] Press Release, U.S. Rep. Michael Grimm (June 11, 2012).

The bill would require the Securities and Exchange Commission (the "SEC") to ease certain restrictions on BDCs, with the goal of making it easier for BDCs to raise capital for small and mid-sized companies.

Investment adviser subsidiaries. The bill would amend Section 60 of the 1940 Act to allow BDCs to own securities issued by registered investment advisers.

Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 eliminated the exemption for registration of investment advisers that had fewer than 15 clients. In the pre-Dodd-Frank days, BDCs sometimes formed or acquired unregistered investment advisers to manage their assets or those of their investors, allowing them to recapture investment advisory fees for the benefit of investors. The elimination of the "small adviser" exception meant that BDCs could not own captive investment advisers without an SEC exemptive order. If enacted, the bill would remove this restriction.

Increase in leverage. Any debt or senior security issued by a BDC must have asset coverage of 200 percent, which is less restrictive than the 300 percent asset coverage requirement imposed on traditional closed-end funds and mutual funds. The bill would reduce the 200 percent asset coverage requirement for BDCs to 150 percent. That is, the bill would require BDCs to hold $3 for every $2 they borrow to lend to small businesses. This reduction in the asset coverage requirement means that BDCs would be able to incur more leverage, thus allowing them to raise more money to invest in portfolio companies.

Preferred stock. The 1940 Act requires BDCs to treat preferred stock as if it were a borrowing for certain purposes. That is, a BDC that issues preferred stock would be subject to the 200 percent asset coverage requiremen,t as if the BDC had leveraged by issuing debt. Also, the 1940 Act permits BDCs to issue only one class of preferred stock.

The bill would eliminate the asset coverage requirement that currently applies to preferred stock. Moreover, it would allow BDCs to issue more than one class of preferred stock. If the bill is enacted, these changes would allow BDCs to raise additional capital by issuing preferred stock.

Registration parity. The bill would require the SEC to amend various rules under the Securities Act within 180 days after enactment that would streamline offering and reporting requirements, effectively allowing BDCs to use the securities offering rules available to Exchange Act reporting issuers.

- *Rule 405.* The bill would require the SEC to revise Rule 405 to remove the exclusion of BDCs from the definition of "well-known seasoned issuer" ("WKSI") and to add registration statements filed on Form N-2 to the definition of "automatic shelf registration statement." As a WKSI, a BDC would have less restrictive disclosure requirements, and could file automatic shelf registrations.

- *Rules 168 and 169.* The bill would require the SEC to remove the exclusion of BDCs from Rules 168 and 169. Rule 168 provides a safe harbor for reporting companies for disclosing certain factual communications and forward-looking information.

- *Rules 163 and 163A.* The bill would require the SEC to remove the exclusion of BDCs from Rules 163 and 163A. These rules provide a safe harbor for WKSIs with respect to prohibitions of pre-filing offers and communications, subject to certain conditions.

- *Rule 134.* The bill would require the SEC to remove the exclusion of BDCs from Rule 134. Rule 134 provides a safe harbor for issuers that make certain communications before the SEC declares a registration statement to be effective.

- *Rules 138 and 139.* The bill would require the SEC specifically to include BDCs in Rules 138 and 139. These rules provide safe harbors for broker-dealers that provide market analysis and reports that do not constitute offers of securities under the Securities Act.
- *Rule 164.* The bill would require the SEC to remove the exclusion of BDCs from Rule 164. Rule 164 provides a safe harbor for issuers that use post-filing "free writing prospectuses." An unintentional or immaterial failure to file or delay in filing free writing prospectuses would not result in a violation of section 5(b)(1) of the Securities Act, subject to certain conditions.
- *Rule 433.* The bill would require the SEC specifically to include BDCs. Rule 433 describes when seasoned issuers, WKSIs, and non-reporting and unseasoned issuers may use free writing prospectuses.
- *Rule 415.* The bill would require the SEC to revise Rule 415 to: (a) state that the registration of securities provided by that rule includes securities by a BDC registered on Form N-2 and (b) provide an exception for a BDC from the certain undertaking requirements required by Form N-2. In effect, BDCs would be able to use continuous or delayed offerings.
- *Rule 497.* The bill would require the SEC to amend Rule 497 to allow BDCs to file a form of prospectus that is similar to the process for filing post-effective prospectuses provided by Rule 424(b).
- *Rules 172 and 173.* The bill would require the SEC to revise rules 172 and 173 to remove the exclusion of BDCs. Rule 172 exempts post-effective confirmations and notices of allocations of securities sold from the requirements of section 5(b)(1) of the Securities Act. Rule 173 allows an underwriter or broker to send investors a notice that the sale was made pursuant to a registration statement or a transaction in which delivery of a prospectus would have been required but for the exemption provided by Rule 172. This change places BDCs on parity with other issuers.

Incorporation by reference and shelf offerings. Also, significantly, the bill would require the SEC to amend Form N-2, the form used by BDCs to register their securities under the Securities Act, to allow BDCs:

- To incorporate by reference reports and documents that they have filed under the Exchange Act requirements; and
- To file automatic shelf offerings, for BDCs that qualify as a WKSI.

These changes would streamline the registration process and give more flexibility in making public offerings.

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For more information about BDCs, see Morrison & Foerster's publications, An Alternative for Private Equity: BDCs and Frequently Asked Questions About Business Development Companies.

Contact:

Anna T. Pinedo
(212) 468-8179
apinedo@mofo.com

Jay Baris

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