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BDC Master Feeder Funds on the Horizon – No-Action Relief Granted to One Issuer

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The staff of the SEC's Division of Investment Management said that it would not recommend enforcement action if a business development company (BDC) reorganizes into a master-feeder structure. The relief will also be available to future Feeder Funds in the same structure.

Although the staff granted the requested relief in this case, it said that other BDCs cannot rely on this relief. Thus, other BDCs that wish to utilize a master-feeder structure will have to seek separate relief. The staff indicated that it was "willing to consider similar requests from other BDCs."

THE PROPOSED STRUCTURE

Under the proposed arrangement, an existing Feeder Fund will elect to be treated as a BDC and offer its shares in a continuous public offering for a finite term between 5 and 25 years. The Feeder Fund will invest all or substantially all of its assets in a Master Fund. Additional Feeder Funds may be offered in the future.

The Master Fund has elected to be treated as a BDC and invests primarily in privately negotiated loans to private middle market U.S. companies and will continuously offer its common shares on a private placement basis. It will have an indefinite life and will not list its shares on a securities exchange. The Master Fund intends to offer a quarterly share repurchase program.

No Feeder Fund will engage in any investment or borrowing activity other than on an indirect basis through its holding of shares of the Master Fund. Each Feeder Fund intends to quarterly tender for a certain amount of its outstanding shares. Because a Feeder Fund will invest substantially all of its assets in the Master Fund, each Feeder Fund's quarterly tender offer will be conducted in parallel with that of the Master Fund. As the Feeder Fund approaches the end of its finite term, the Feeder Fund's board of trustees will authorize its liquidation and dissolution. The Feeder Fund will affect the dissolution by selling to the Master Fund all of the Master Fund's shares owned by the Feeder Fund.

A Feeder Fund may have a front-end sales charge and/or distribution/shareholder servicing fees, although Feeder Funds with the same or similar term may not currently have differing sales charges or distribution/shareholder servicing fees. At some point, however, a Feeder Fund may offer its shares under a multiple class arrangement if it receives an SEC order that allows the fund to charge different sales loads, distribution fees or shareholder servicing fees for different classes.

THE RELIEF

Section 2(a)(48) and Section 55(a) of the 1940 Act.

Section 2(a)(48) of the 1940 Act defines a BDC as an entity that is operated for the purpose of investment in securities described in Sections 55(a)(1)–55(a)(3) of the 1940 Act. In general, such securities are issued by "eligible portfolio companies'" as defined in Section 2(a)(46) of the 1940 Act. BDCs must also make available significant managerial assistance to the issuers of such securities.

Section 2(a)(46) excludes investment companies, including BDCs, from the definition of eligible portfolio company. As a result, a Feeder Fund's investment in the Master Fund would not be an investment in an eligible portfolio company. In addition, a Feeder Fund would not make significant managerial assistance available to the issuers of securities held by the Master Fund. Thus, the applicants sought relief from the provisions of Section 2(a)(48) in order for the Feeder Funds to elect to be treated as BDCs.

Section 55(a) of the 1940 Act generally prohibits a BDC from acquiring any assets (other than those described in Sections 55(a)(1)–55(a)(7)) unless, at the time of acquisition, at least 70% of its total assets are held in "qualifying assets" including (i) securities issued by eligible portfolio companies in a private placement; (ii) securities of eligible portfolio companies already controlled by the BDC, regardless of the method of offering; (iii) securities of certain financially distressed companies that are purchased in a private offering; and (iv) cash, government securities and high-quality, short-term debt. Since the Feeder Funds will invest only in shares of the Master Fund, which is not an eligible portfolio company, the applicants sought relief from the provisions of Section 55(a).

The staff confirmed that it would not recommend enforcement action under either Section 2(a)(48) or Section 55(a) if the applicants established the proposed master-feeder structure and the Feeder Funds elect to be treated as BDCs.

Section 7(a) of the 1940 Act.

Section 7(a) generally prohibits an investment company, unless registered under Section 8 of the 1940 Act, from offering to sell, selling or delivering after sale any security. Section 8 does not apply to BDCs, and, accordingly, neither the Master Fund nor any Feeder Fund will register under Section 8.

The applicants noted that the Feeder Funds will invest only in shares of the Master Fund and, therefore, may not satisfy the definition of a BDC in Section 2(a)(48), as discussed above. In that case, a Feeder Fund might be in violation of Section 7(a) absent the requested relief. The staff stated that it would not recommend enforcement action against the Feeder Funds under Section 7(a) if the Feeder Funds elect to be regulated as BDCs.

Section 54 (a) of the 1940 Act.

Section 54(a) provides that a company that meets the Section 2(a)(48) definition of a BDC may elect to be treated as a BDC. Among other things, a BDC must invest primarily in privately offered securities of eligible portfolio companies. Since the Feeder Funds will invest only in the shares of the Master Fund, which will not be an eligible portfolio company, the Feeder Funds could not elect to be treated as BDCs absent the requested relief.

The SEC staff confirmed that it would not recommend enforcement action under Section 54(a) if a Feeder Fund invests only in shares of the Master Fund and thus only indirectly hold interests in securities described in Sections 55(a)(1)–55(a)(3) but nevertheless elects to be treated as a BDC.

Section 23(c) and Rule 23c-1 of the 1940 Act.

Section 23(c) (which applies to a BDC through Section 63 of the 1940 Act) generally prohibits a BDC from purchasing its own securities. The SEC may, however, permit such purchases by rule.

Pursuant to this statutory authority, the SEC adopted Rule 23c-1, which permits a closed-end fund to purchase its securities for cash subject to certain conditions. Since each of the Feeder Funds will have a finite term, the planned liquidation of such Feeder Funds will require the Master Fund to purchase its shares from a liquidating Feeder Fund for cash. In general, such purchase will be made in compliance with Rule 23c-1, except that the Master Fund will comply with the asset coverage requirements applicable to BDCs (i.e., 200%) rather than the asset coverage requirement included in Rule 23c-1 (i.e., 300%). In addition, Rule 23c-1 requires that the seller of a security may not, to the knowledge of the issuer, be an affiliated person of the issuer. Since each Feeder Fund will be an affiliated person of the Master Fund, the purchase of Master Fund shares from a liquidating Feeder Fund would not be consistent with Rule 23c-1.

The applicants argued that the proposed repurchase of Master Fund shares would not raise the potential issues that Rule 23c-1 was designed to address, namely overreaching by an affiliated shareholder, because the finite term (and related liquidation) of each Feeder Fund is a key aspect of the proposed arrangement and will be fully disclosed to investors. Moreover, all Feeder Funds will liquidate and dissolve in the same manner, and thus the risk of overreaching is minimal.

Based on the applicant's representations, the staff said that it would not recommend enforcement action under Section 23(c) and Rule 23c-1.

OUR TAKE

The proposed master-feeder structure will enable the applicants to consolidate most operating expenses of a BDC at the Master Fund level. Each Feeder Fund will share pro rata in the Master Fund's expenses but, since each Feeder Fund won't separately incur the costs of investing in middle market debt, the applicants could spread such costs over multiple Feeder Funds. Over time, this structure should help to create economies of scale to the benefit of shareholders.

Offering different Feeder Funds with different finite terms and fee structures may also allow the applicants to sell different Feeder Funds though different distribution channels, thereby broadening the potential pool of investors and, possibly, increasing the Master Fund's pool of assets. In turn, this may lead to a relatively lower expense level at the Master Fund, which will be shared pro rata by the Feeder Funds. Net-net, this should serve to reduce the shareholders' costs.

It seems clear, however, that the next logical step would be to allow BDCs to offer multiple classes of shares. A multi-class structure would allow BDCs to offer their shares through various distribution channels without incurring the costs of setting up separate Feeder Funds. A multi-class structure should further reduce the costs incurred by the underlying shareholders of a BDC and, arguably, would be a less complex structure. Several multi-class exemptive applications are currently pending with the SEC; we hope that the SEC processes these applications promptly.

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