FREQUENTLY ASKED QUESTIONS ABOUT BUSINESS DEVELOPMENT COMPANIES

Understanding Business Development Companies

What is a "business development company"?

Business development companies ("BDCs") are special investment vehicles designed to facilitate capital formation for small and middle-market companies. BDCs are closed-end investment companies; however, BDCs are exempt from many of the regulatory constraints imposed by the Investment Company Act of 1940, as amended (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 (1) 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 (2) has elected business development company status. As a general matter, a BDC must also maintain at least 70% of its investments in eligible assets before investing in non-eligible assets.

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 then file a Form N-6 (intent to file a notification of election) and a Form 54A (election to be regulated as a BDC).

BDCs are also typically registered under the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and are subject to all registration and reporting requirements under those two statutes. In order to register under the Securities Act, a BDC must prepare a registration statement on Form N-2. For more information regarding the registration process for BDCs, *see* "Disclosure Requirements" below.

Why are BDCs attractive?

BDCs can be more attractive than other types of investment funds for several reasons. First, BDCs provide investors with the same degree of liquidity as other publicly traded investments, unlike open-end investment companies, or mutual funds, in which investors can only sell and buy shares directly to, and from, the fund itself. Investors also do not need to meet the income, net worth or sophistication criteria imposed on private equity investments. Second, managers of BDCs have access to "permanent capital" that is not subject to shareholder redemption or the requirement that capital (as well as returns on such capital) be distributed to investors as investments are realized or otherwise generate income. Third, managers of BDCs may immediately begin earning management fees after the BDCs have gone public and, unlike other registered funds, charge performance fees. Fourth, BDCs have greater flexibility than other types of registered investment funds to use leverage and engage in affiliate transactions with portfolio companies. In fact, BDCs have increasingly focused in recent years on mezzanine and debt investments that typically generate current income and provide greater upside potential.

However, BDCs (1) must maintain low leverage (total debt outstanding cannot exceed total equity); (2) typically seek to build a diversified portfolio of investments (no single investment can account for more than 25% of total holdings); (3) are required by the 1940 Act to distribute a minimum of 90% of their taxable earnings quarterly (in practice, most pay out 98% of taxable income and all short-term capital gains); and (4) pay out dividends at a relatively stable level as most of the their portfolio investments are in debt securities.

What types of investments are permissible for BDCs?

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

- privately issued securities purchased from issuers that are "eligible portfolio companies" (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 (a controlling interest is presumed if the BDC owns more than 25% of a portfolio company's voting securities);
- privately issued securities of companies subject to a bankruptcy proceeding, reorganization, insolvency or similar proceeding or otherwise unable to meet their obligations without material assistance;
- 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.

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.

In addition, under Section 12(d)(3) of the 1940 Act, a BDC generally cannot acquire securities issued by (1) a broker-dealer, (2) an underwriter or (3) an investment adviser of an investment company or a registered investment adviser, unless such issuer is (A) a corporation all the outstanding securities of which are (or after such acquisition will be) owned by one or more registered investment companies and (B) primarily engaged in the business of underwriting and distributing securities if the gross income of such issuer normally is derived principally from such business or related activities. However, the SEC has granted no-action relief from such prohibition in two cases. In the first, a BDC was organized in a master feeder structure and the master fund proposed to form one or more private funds for which it would serve as the investment adviser and the feeder funds would hold membership units in the master fund.[1] In the second, an internally managed BDC, which was registered as an investment adviser and served as a sub-adviser for an unaffiliated externally managed BDC, sought to transfer the sub-advisory agreement to its wholly owned subsidiary.[2]

Further, the SEC has granted no-action relief from Sections 2(a)(48) and 55(a) of the 1940 Act to enable a feeder fund to elect to be treated as a BDC notwithstanding the fact that the feeder fund's investment in the master fund would not be an investment in an eligible portfolio company and the feeder fund would not make significant managerial assistance available to the issuers of securities held by the master fund.[3]

What types of securities may BDCs issue?

BDCs may issue debt and equity securities, as well as derivative securities, including options, warrants and rights that convert into voting securities. Any debt or senior security issued by a BDC must have asset coverage of 200%, which is less restrictive than the 300% asset coverage requirement imposed on traditional closed-end funds and mutual funds. Also, no dividends can be declared on common stock unless the BDC's debt and senior securities, if any, have asset coverage of 200%.

Can a BDC issue convertible securities?

A BDC is generally able to issue convertible securities, including convertible debt securities and convertible preferred stock, where the convertibility feature is not the predominant factor in the determination of the market value upon issuance. Convertible securities are generally considered "senior securities" under the 1940

1 *See* New Mountain Finance Corporation, SEC No-Action Letter, Division of Investment Management (Nov. 4, 2013).

2 *See* Main Street Capital Corporation, SEC No-Action Letter, Division of Investment Management (Nov. 7, 2013).

3 *See* Carey Credit Income Fund and Carey Credit Income Fund 2015 T, SEC No-Action Letter, Division of Investment Management (July 15, 2015).

Act requiring an issuing BDC to have asset coverage of at least 200% prior to issuing the convertible securities. However, if the conversion option is such a significant investment characteristic of the convertible security as to make it, in substance, not a senior security but a right to purchase voting securities, the BDC must instead look to Section 61(a)(3) of the 1940 Act. Section 61(a)(3) allows a BDC to, among other things, issue warrants, options or rights to subscribe for or convert into voting securities if the following conditions are satisfied:

- the warrants, options or rights expire by their terms within ten years;
- the underlying voting securities are not separately transferable from the warrants, options or rights, unless no class of such warrants, options or rights and the underlying voting securities has been publicly distributed;
- the exercise or conversion price is not less than the current market value at the date of issuance, or if no such market value exists, the current net asset value ("NAV") of the underlying voting securities; and
- the proposal to issue the warrants, options or rights is authorized by the BDC's shareholders and such issuance must be approved by a majority of the BDC's directors on the basis that such issuance is in the best interests of the BDC and its shareholders.

Can a BDC repurchase its own securities?

Pursuant to Section 23(c) of the 1940 Act, a BDC is permitted to repurchase its own securities, including debt and equity securities, if the repurchase (i) occurs on a securities exchange and the BDC has informed its shareholders of its intent to purchase the securities within the preceding six months or (ii) is made pursuant to a tender offer and a reasonable opportunity to sell has been given to all holders of the class of securities proposed to be repurchased. A BDC also may repurchase its outstanding debt securities for cash from a non-affiliate, subject to the conditions set forth in Rule 23c-1(a) under the 1940 Act which include, among others, the following:

- the dividends payable under the debt securities proposed to be repurchased are not in arrears;
- all debt securities that are senior to the debt securities proposed to be repurchased must have an asset coverage of at least 300% and all senior securities that are stock must have an asset coverage of at least 200%, in each case, immediately after such repurchase;
- the repurchase is made at or below market value;
- the repurchase is not made in a manner or on a basis which discriminates unfairly against any holder of the class of debt securities proposed to be repurchased; and
- the BDC files with the SEC a copy of any written solicitation used to repurchase the debt securities.

Due to significant discounts recently between the book and market value for many BDC stocks, many BDCs have recently authorized share repurchase programs allowing them to repurchase their outstanding shares of common stock at prices below NAV per share. Under a share repurchase program, a BDC may, but is not obligated to, repurchase its shares of common stock in the open market or in privately negotiated transactions from time to time. Any share repurchases made by a BDC must comply with the requirements of Rule 10b-18 under the Exchange Act.[4] The timing, manner, price and amount of any share repurchases may be determined by a BDC's board of directors in its discretion and the share repurchase program may be suspended, extended, modified or discontinued by the BDC at any time.

What constitutes "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. Note that 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.

May BDCs operate Small Business Investment Companies?

BDCs may create wholly owned subsidiaries which are licensed by the Small Business Administration

4 For more information regarding share repurchase programs under Rule 10b-18, see our "Frequently Asked Questions About Rule 10b-18 and Stock Repurchase Programs," available at: https://media2.mofo.com/documents/faq-rule-10b-18-stock-repurchases.pdf.

(“SBA”) to operate as Small Business Investment Companies (“SBICs”). The SBIC subsidiary is able to rely on an exclusion from the definition of “investment company” under the 1940 Act. The SBIC subsidiary issues SBA-guaranteed debentures, subject to the required capitalization of the SBIC subsidiary. SBA-guaranteed debentures carry long-term fixed rates that are generally lower than rates of comparable bank and other debt. Under the regulations applicable to SBICs, an SBIC may have outstanding debentures guaranteed by the SBA generally in an amount of up to twice its regulatory capital, which generally equates to the amount of its equity capital. The SBIC regulations currently limit the amount that an SBIC subsidiary may borrow to a maximum of $150 million, assuming that it has at least $75 million of equity capital. The SBIC is subject to regulation and oversight by the SBA, including requirements with respect to maintaining certain minimum financial ratios and other covenants. In addition, an SBIC subsidiary in certain instances may have to elect to be treated as a BDC and file with the SEC a registration statement on Form N-5

In addition, a BDC may be deemed an indirect issuer of any class of “senior security” issued by its direct or wholly owned SBIC subsidiaries. In such case, the senior securities will not be treated as senior securities or indebtedness for purposes of the BDC’s asset coverage requirement of 200%, but only if the SBIC subsidiary has issued indebtedness that is held or guaranteed by the SBA.

What is the tax treatment of BDCs?

BDCs are typically organized as limited partnerships in order to obtain pass-through tax treatment. However, a BDC cannot be a “publicly traded partnership” for federal income tax purposes. Thus, if the BDC is to be a partnership for tax purposes, either (a) its interests cannot be traded on an exchange or on a secondary market or equivalent, or (b) it must qualify for one of the exceptions to treatment as a “publicly traded partnership” for U.S. federal income tax purposes. Instead of being treated as a partnership for tax purposes, some BDCs have been organized as corporations and have obtained pass-through tax treatment by qualifying as regulated investment companies (“RICs”) under Subchapter M of the Internal Revenue Code of 1986, as amended. To qualify as an RIC, a BDC must, among other things, elect to be so treated, must hold a diversified pool of assets and must distribute substantially all (*e.g.*, 90%) of its taxable income each year. Generally, distributions by a BDC are taxable as either ordinary income or capital gains in the same manner as distributions from mutual funds and closed-end funds, and a BDC shareholder will recognize taxable gain or loss when it sells its shares.

How are portfolio investments valued?

BDCs cannot establish loan loss reserves to absorb losses in their loan portfolios. Instead, BDCs must mark their loan portfolio to fair value on a quarterly basis, with any unrealized gains or losses reflected on their income statements. Fair value is determined through the cooperation of a BDC’s management and board of directors, often with participation from internal auditors and third-party valuation firms. The adoption in 2008 of SFAS 157, Fair Value Measurements, resulted in slight adjustments to BDC balance sheets and income statements as BDC fair value procedures were already similar to SFAS 157 requirements. Currently, the majority of BDC portfolio investments are deemed to be valued in the Level 3 category with unobservable inputs. As a result, BDCs conduct yield analysis and enterprise value calculations to arrive at individual portfolio valuations.

Affiliate Transactions

What are the various types of restricted transactions?

Unlike traditional investment companies, which are subject to the affiliate 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 BDCs 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 BDCs and describes the following four types of transactions (“Restricted Transactions”) that such persons (and certain affiliated persons of those persons), acting as principal, may not enter into with BDCs without prior approval:

- an affiliate may not knowingly sell any securities or other property to a 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 a 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 a BDC, or a company controlled by it, with limited exceptions; and
- an affiliate is prohibited from knowingly effecting any joint transactions with a BDC, or a company controlled by it, in contravention of rules of the Securities and Exchange Commission (the "SEC").

What are the categories of BDC affiliates regulated by Section 57?

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

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" of a BDC 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.

The SEC has issued guidance recognizing that, in many circumstances, limited partners and shareholders should be treated comparably for purposes of determining whether a Restricted Transaction involves a first tier affiliate or second tier affiliate of a BDC. For example, where a limited partner of a private fund (under common control with a BDC by the BDC's investment adviser), who also owns 5% or more (but 25% or less) of the private fund's outstanding voting securities, is a first tier affiliate of the BDC solely because the private fund is organized as a limited partnership and the limited partner is seeking to co-invest with the BDC, the limited partner may be treated as if it were a shareholder of the private fund for purposes of determining whether it is a second tier affiliate of 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 in the same manner as a second tier affiliate when engaging in Restricted Transactions with the BDC. However, the affiliate 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 to these FAQs 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 is a table showing examples of affiliate transactions of BDCs and guidance on whether such transactions require the SEC's or the BDC's board of directors' approval. Note that an examination of all potential affiliate transactions is beyond the scope of these FAQs.

Internal Versus External Management Issues

What are the advantages of internal 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 also 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.

Note that it should be possible to limit the activities of investment professionals invested in an internally managed BDC to avoid registration under the Investment Advisers Act of 1940 (the "Advisers Act"), given that the investment professionals invested in the few existing internally managed BDCs have not yet registered under the Advisers Act.

What are the advantages of external management?

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 requirements relating to custody of assets. However, the investment advisory agreement memorializing the third party contract is subject to the requirements of the 1940 Act, which include, among other things, approval by the board of directors and shareholders of the BDC. 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 also 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.

Registration as an investment adviser also 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.

What fees may be paid to an investment adviser?

Typically, an investment adviser is paid a management fee equal to an annual rate of 1.75% to 2.5% of the gross assets of the BDC's portfolio (including any borrowings), paid quarterly in arrears. Section 205(b)(3) of the Advisers Act permits an investment adviser of a BDC to also 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. The performance fee is typically paid out as follows:

- 0% of all net investment income earned at or below a "hurdle rate" of 7%;
- 100% of all net investment income earned above the 7% hurdle rate but below a "catch-up rate" of 8.75%; and
- 20% of all net investment income earned above the 8.75% "catch-up rate."

Finally, as is the case with traditional closed-end funds, brokers that sell BDC shares generally receive significant compensation from front-end sales loads charged to investors.

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:

- 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);
- 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;
- the voting securities are non-transferable (except by gift, will or intestacy); and
- 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).

How may a BDC compensate its management?

Internally managed BDCs may compensate management through either (i) performance-based compensation, including issuance of at-the-market options, warrants or rights under an executive compensation plan; or (ii) through the maintenance of a profit-sharing plan. If an internally managed BDC elects not to adopt either of these options, they may compensate management through the use of cash compensation. An externally managed BDC which receives an incentive fee cannot participate in any equity-based compensation plan.

Disclosure Requirements

What is a Form N-2?

A BDC that registers under the Securities Act 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 amount of shares being offered, price, underwriting arrangements and compensation;
- the intended use of the proceeds;
- investment objectives and policies, including any investment restrictions;
- risk factors associated with investing in the BDC, including special risks associated with investing in a portfolio of small and developing or financially troubled businesses; and
- the management of the BDC, including directors, officers and the investment adviser.

The registration statement must also include financial statements of the BDC meeting the requirements of Regulation S-X. In addition, BDCs with certain significant subsidiaries may need to provide separate financial statements or summarized financial information for those subsidiaries as required by Regulation S-X. Rule 3-09 under Regulation S-X describes, among other things, the circumstances under which separate financial statements of an unconsolidated majority-owned subsidiary are required to be filed with the SEC. Rule 4-08(g) under Regulation S-X generally requires registrants to present in the notes to their financial statements summarized financial information for all unconsolidated subsidiaries when any unconsolidated subsidiary, or combination of unconsolidated subsidiaries, meets the definition of a "significant subsidiary" in Rule 1-02(w) under Regulation S-X. If a BDC is required to present summarized financial information, the SEC generally will not object if the BDC presents summarized financial information in the notes to the financial statements only for each unconsolidated subsidiary which individually meets the definition of a "significant subsidiary" in Rule 1-02(w) but does not present summarized financial information in the notes to the financial statements for all unconsolidated subsidiaries.

What information regarding prospective portfolio companies and the BDC's investment methodology must be included?

To the extent that a BDC has identified but not yet purchased prospective portfolio companies in anticipation of its initial public offering ("IPO"), 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 making investment decisions 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 (1) identify each portfolio company; and (2) disclose the following: (A) the nature of the portfolio company's business, (B) the title, class, percentage of class and value of the portfolio company's securities held by the BDC, (C) the amount and general terms of all loans to the portfolio company, and (D) the relationship of the portfolio company to the BDC.

Is the SEC's new reporting regime for registered investment companies applicable to BDCs?

On October 13, 2016, the SEC adopted a new reporting regime, including new reporting forms and amendments to existing rules, for registered investment companies. Although BDCs are not required to register as investment companies under the 1940 Act, BDCs elect to be subject to certain specialized provisions of the 1940 Act. As a result, BDCs are generally subject to a different reporting regime than registered investment companies. However, the amendments to Articles 6 and 12 of Regulation S-X included as part of the new reporting regime are applicable to both registered investment companies and BDCs.

The amendments to Regulation S-X require standardized, enhanced disclosure about derivatives in the BDC's financial statements. Previously, Regulation S-X did not prescribe specific information for most types of derivatives, including swaps, futures and forwards. However, Regulation S-X will now require prominent placement of disclosure regarding investments in derivatives in a BDC's schedule of investments rather than allowing such schedules to be disclosed in the notes to the BDC's financial statements.[5] In addition, the amendments to Regulation S-X modify the required disclosures for investments in and advances to BDC affiliates.[6] The SEC expects that the amendments to Regulation S-X will assist investors with comparing BDCs and increase transparency regarding the use of derivatives by BDCs. The amendments to Regulation S X became effective on August 1, 2017.

What are the ongoing reporting requirements for BDCs?

BDCs are required to (1) file a notice with the SEC pursuant to which the BDC elects to be treated as a BDC, (2) register a class of equity securities under Section 12 of the Exchange Act, (3) file periodic reports under the Exchange Act, including 10-Ks, 10-Qs and 8-Ks, and (4) file proxy statements pursuant to Section 14(a) of the Exchange Act. Additionally, management must report their ownership of, and trading in, securities in the BDC and are subject to the short swing profits rules.

Can a BDC use a shelf registration statement for registering multiple offerings of securities?

Yes, a BDC can use a shelf registration statement on Form N-2 to register multiple offerings of securities. However, the SEC has recently imposed a limit on the cumulative dilution to a BDC's current NAV per share that a BDC may incur while using a shelf registration statement to sell shares of its common stock at a price below NAV. A BDC can complete multiple offerings off of an effective shelf registration statement only to the extent that the cumulative dilution to the BDC's NAV per share does not exceed 15%. Once the cumulative dilution exceeds 15%, the BDC must file a post-effective amendment to the shelf registration statement or file a new shelf registration statement. A BDC also must provide (1) in the related prospectus supplement for the offering, specific dilution tables showing the dilutive or accretive effects that the offering will have on different types of investors and a chart based on the number of shares offered and the discount to the most recently determined NAV, and (2) in the shelf registration statement or post-effective amendment, an additional undertaking that it will file a post-effective amendment if its common stock is trading below NAV.

BDCs typically use shelf registration statements to issue debt and equity securities. Debt securities are issued by BDCs from time to time either in follow-on offerings or takedowns from a medium-term note program (in which case a prospectus supplement for the medium-term note program is first filed with the SEC).[7] BDCs also frequently list their debt securities on a national securities exchange (such debt securities are referred to as "baby bonds" due to their low minimum denominations). Equity securities are issued by BDCs from time to time either in follow-on offerings or in "at-the-market" offerings. An "at-the-market" offering is an offering of securities into an existing trading market for outstanding shares of the same class at other than a fixed price on, or through the facilities of, a national securities exchange, or to or through a market maker otherwise than on an exchange. Equity distribution programs often are established for "at-the-market" offerings (in which case a prospectus supplement for the equity distribution program is first filed with the SEC), and these programs are considered the equity analogue to a medium-term note program.[8]

5 The amendments to Regulation S-X generally re-number the current schedules in Article 12 of Regulation S-X, break-out the reporting of derivatives currently on Schedules 12 and 13 into separate schedules and require new schedules for open futures contracts, open forward foreign currency contracts and open swap contracts. Specifically, for each open written options contract, new Rule 12-13 under Regulation S-X requires BDCs to disclose the following information: (1) the description of the contract; (2) the counterparty; (3) the number of contracts; (4) the notional amount; (5) the exercise price; (6) the expiration date; and (7) the value. For each open futures contract, new Rule 12-13A under Regulation S-X requires BDCs to disclose the following information: (1) the description of the contract; (2) the number of contracts; (3) the expiration date; (4) the notional amount; (5) the value; and (6) the unrealized appreciation/depreciation. For each open forward foreign currency contract, new Rule 12-13B under Regulation S-X requires BDCs to disclose the following information: (1) the amount and description of currency to be purchased; (2) the amount and description of currency to be sold; (3) the counterparty; (4) the settlement date; and (5) the unrealized appreciation/depreciation. Under new Rule 12-13C under Regulation S-X, BDCs will also be required to report the counterparty to each transaction (except for exchange-traded and centrally cleared swaps), the contract's value and any upfront payments or receipts.

6 The amendments to Regulation S-X modify Column C of the schedule to Rule 12-14 under Regulation S-X to include "net realized gain or loss for the period" and modify Column D to include "net increase or decrease in unrealized appreciation or depreciation for the period" for each affiliated investment.

7 For more information on medium-term note programs, *see* our "Frequently Asked Questions About Medium-Term Note Programs," available at: http://media.mofo.com/files/Uploads/Images/FAQAtTheMarketOfferings.pdf.

8 For more information on "at-the-market" offerings, *see* our Frequently Asked Questions About At-the-Market Offerings," available at: http://media.mofo.com/files/Uploads/Images/080818FAQsMTN.pdf.

Can a BDC qualify as an "emerging growth company" and what are the benefits?

Yes, a BDC may qualify as an "emerging growth company" ("EGC"), which is a new category of issuer under Title I of the Jumpstart Our Business Startups (JOBS) Act enacted on April 5, 2012, which amends Section 2(a) of the Securities Act and Section 3(a) of the Exchange Act. An EGC is an issuer with total annual gross revenues of less than $1.07 billion (adjusted from $1 billion in March 2017, and subject to inflationary adjustment by the SEC every five years), and would continue to have this status until: (i) the last day of the fiscal year in which the issuer had $1.07 billion in annual gross revenues or more; (ii) the last day of the fiscal year following the fifth anniversary of the issuer's IPO; (iii) the date on which the issuer has, during the previous three-year period, issued more than $1.07 billion in non-convertible debt; or (iv) the date when the issuer is deemed to be a "large accelerated filer" as defined by the SEC. However, a BDC issuer will not be able to qualify as an EGC if it first sold its common stock in an IPO prior to December 8, 2011.

The benefits for a BDC of qualifying as an EGC include the following:

- may file a registration statement with the SEC on a confidential basis;
- expanded range of permissible pre-filing communications made to qualified institutional buyers or institutional accredited investors;
- only need to provide two years of audited financial statements to the SEC (rather than three years), and the auditor attestation on internal controls requirement may be delayed;
- exemption from the mandatory say-on-pay vote requirement and the Dodd-Frank Act required CEO pay ratio rules (to be adopted by the SEC), and the ability to use certain smaller reporting company scaled disclosure;
- no requirement to comply with any new or revised financial accounting standard until the date that such accounting standard becomes broadly applicable to private companies; and
- no longer subject to any rules requiring mandatory audit firm rotation or a supplement to the auditor's report that would provide additional information regarding the audit of the issuer's financial statements (no such requirements currently exist).

An EGC may forego reliance on any exemption available to it. However, if it chooses to comply with financial reporting requirements applicable to non-EGCs, the EGC must comply with all such standards and cannot selectively opt in or opt out of requirements. Any election must be made at the time the EGC files its first registration statement or Exchange Act report.

Can a BDC conduct a road show? What about a "non-deal" road show?

During the offering process, a BDC's management may make presentations to invited groups of institutional investors, money managers and other potential investors. This is commonly referred to as a "road show" and is usually organized by the underwriters in the offering. A BDC may also conduct a "non-deal" road show, in which case the BDC meets with institutional investors even though no offering is then contemplated. In either case, the BDC must give consideration as to whether the communications or presentations made during the road show may be deemed to be written communications in connection with an offering of the BDC's securities. Written communications (other than the offering prospectus) may not be used in connection with an offering of a BDC's securities because BDCs, along with blank-check companies, shell companies, penny-stock issuers, asset-backed issuers and investment companies, are not permitted to rely on Rule 433 under the Securities Act and use free writing prospectuses ("FWPs").[9] Although the SEC and the courts interpret the term "offer" broadly, a live road show is generally not considered a written communication. A live road show includes any of the following:

- a live, in-person road show to a live audience;
- a live, in real-time road show to a live audience that is transmitted graphically;
- a live, in real-time road show to a live audience that is transmitted to an "overflow room";
- a webcast or video conference that originates live and in real-time at the time of transmission and is transmitted through video conferencing facilities or is webcast in real-time to a live audience; and
- a slide deck or other investor presentation used during any such live road show, unless investors are permitted to print or take copies of such information.

9 The term "free writing prospectus" refers to any "written communication" that constitutes an offer to sell or a solicitation of an offer to buy SEC-registered securities and is not (i) a statutory prospectus, (ii) a communication made in reliance on special rules for issuers of asset-backed securities and (iii) a communication given together with or after delivery of a final prospectus. An FWP can only be used after a registration statement is filed.

With respect to the slide deck or investor presentation used in non-deal road shows, it is common practice for BDCs to post their slide decks or investor presentations on their websites and update them periodically. Under certain circumstances, particularly if the BDC is concerned with Regulation FD, a BDC may also file or furnish the non-deal road show materials under cover of Form 8-K. Regulation FD prohibits the intentional disclosure of material non-public information regarding an issuer or its securities to select categories of people, such as broker-dealers, investment advisers, investment companies and other select investors that would typically be the audience for a "non-deal" road show.[10]

Ongoing 1940 Act Requirements

Are there certain requirements regarding the board of directors of a BDC?

Since the enactment of the 1940 Act, Congress and the SEC have emphasized the role that boards of directors play in overseeing investment companies and policing the conflicts between investment companies and their investment advisers. To ensure that a board is unbiased when policing conflicts, a majority of the board of directors must be persons who are not "interested persons" of the BDC. Under the 1940 Act, an "interested person" is defined to include the following, among others: (1) any officer, director and employee of the BDC (however, no person is deemed to be an interested person solely by reason of being a member of the board of directors); (2) a five percent or more voting shareholder of the BDC; (3) a person who is a member of the immediate family of an affiliate of the BDC; (4) legal counsel to the BDC; (5) any affiliated person of the BDC's investment adviser or principal underwriter; or (6) any natural person who the SEC determines to have had a material business relationship in the past two completed fiscal years with the BDC or the BDC's chief executive officer.

In addition to traditional corporate responsibilities and fiduciary duties imposed on the board of directors of a BDC by common law as well as state law, directors are charged with certain responsibilities under the 1940 Act. The board of directors must approve any underwriting agreements, valuation policies, compliance policies and the investment advisory agreement.

10 For more information on Regulation FD, see our "Frequently Asked Questions About Regulation FD," available at: https://media2.mofo.com/documents/faqs-regulation-fd.pdf.

What policies and procedures must the BDC adopt?

A BDC and, if applicable, its external investment adviser, must adopt a code of ethics reasonably designed to prevent certain persons who may have access to information regarding securities trades made on behalf of the BDC (such people are referred to as "access persons") from engaging in any fraudulent, deceptive, or manipulative acts. The code of ethics must require periodic reporting by such access persons and imposes recordkeeping requirements on the BDC and investment adviser, as applicable. Under the periodic reporting requirements, the access persons must provide three types of reports: (i) an initial holdings report, disclosing the securities held by the person upon becoming an "access person"; (ii) a quarterly transaction report, disclosing transactions during a calendar quarter including the nature of the transactions; and (iii) an annual holdings report, disclosing securities held by the access person at the end of a calendar year. Annually, the BDC must provide its board of directors with a report describing issues arising under the code of ethics, material violations and sanctions in response to material violations of the code of ethics.

Additionally, every registered investment company must adopt and implement policies and procedures reasonably designed to prevent violations of the federal securities laws and must designate a chief compliance officer to oversee the administration of these policies and procedures. The BDC's compliance procedures must address, at a minimum, the following areas: (i) portfolio management processes; (ii) trading practices; (iii) accuracy of disclosures; (iv) safeguards on client assets from advisory personnel; (v) accurate creation of records; (vi) valuation of portfolio holdings; (vii) identification of affiliated persons; (viii) protection of non-public information; and (ix) compliance with the various governance requirements. The compliance procedures must be approved by the board of directors, including a majority of the independent directors. Annually, the board of directors must review the compliance policies to ensure the ongoing effectiveness of the procedures.

Section 31 of the 1940 Act requires that every registered investment company maintain and preserve records as prescribed under the rules adopted by the SEC. The rules require, among other items, that all investment companies maintain and keep current the following documents: (i) all documents relating to the filing of financial statements; (ii) records relating to the purchase and sale of securities (including the commissions paid); (iii) all ledgers reflecting assets and liabilities; (iv) corporate charters; (v) proof of cash balances; (vi) persons and groups of persons authorized to transact in securities; and (vii) brokerage orders. The records may be maintained in electronic format as long as they are arranged and indexed in a manner that permits easy access and a legible true and complete copy of the document can be promptly provided. It is recommended that every BDC adopt a records retention policy to ensure reasonable compliance with the SEC rules.

Furthermore, all securities of the BDC must be held by a custodian meeting the requirements of Section 26(a)(1) of the 1940 Act.

Note that an examination of all of the required policies and procedures are beyond the scope of this FAQ.

Are there any specific insurance requirements a BDC must comply with?

A BDC must provide and maintain a bond issued by a fidelity insurance company to protect the BDC against embezzlement and larceny. The fidelity bond must cover each officer and employee who has access to funds and securities. The amount of coverage is tied to the amount of the BDC's assets.

Miscellaneous

Are there restrictions on investments in BDCs under the 1940 Act?

Yes. Section 12(d)(1)(A) of the 1940 Act prohibits a registered investment company from (1) acquiring more than 3% of another investment company's voting securities; (2) investing more than 5% of its total assets in any one acquired investment company; or (3) investing more than 10% of its total assets in all acquired investment companies. The SEC Staff on more than one occasion has granted exemptive relief to enable registered funds operating as exchange-traded funds to invest in BDCs in excess of the 3% limitation.[11] In granting such relief, the SEC Staff has imposed conditions designed to address the public policy concerns of pyramid structures or investments, including oversight by the acquiring investment company's board of trustees, limitations on layering fees, adoption of policies regarding proxy voting, limitations on the ability to exercise control over an underlying BDC, and the requirement for the acquiring fund and the BDC to enter into participation agreements and provide records to monitor compliance with the provisions of the exemptive relief.

The SEC Staff has also granted exemptive relief to allow a registered open-end fund or unit investment trust (UIT) to rely on Rule 12d1-2 under the 1940 Act to invest in a closed-end fund, which would include a BDC, regardless of whether the two companies hold themselves out to investors as related organizations. Specifically, the SEC Staff noted, for the purposes of Rule 12d1-2, the definition of "group of investment companies" in Section 12(d)(1)(G) of the 1940 Act, does not include closed-end funds.[12]

What is the AFFE disclosure requirement and how has it impacted BDCs?

In June 2006, the SEC adopted amendments to Form N 1A to require any registered open-end fund investing in shares of another fund, including BDCs, to include in its prospectus fee table an additional line item titled "Acquired Fund Fees and Expenses" (the "AFFE disclosure requirement").[13] Under amended Item 3 of Form N-1A, an acquiring fund must aggregate the amount of total annual fund operating expenses of acquired funds (which are indirectly paid by the acquiring fund) and transaction fees (which are directly paid by the acquiring fund over the past year) and express the total amount as a percentage of average net assets of the acquiring fund. The acquiring fund also must include in the expense calculation any transaction fee the acquiring fund paid to acquire or dispose of shares of an acquired fund during the past fiscal year (even if it no longer holds shares of the acquired fund).14

11 *See, e.g., In the matter of Global X Funds et al*., Rel. No. IC-30454 (Apr. 9, 2013); *In the matter of PowerShares Exchange-Traded Fund Trust et al*., Rel. No. 32035 (Mar. 22, 2016). As made applicable to BDCs by Section 60 of the 1940 Act, Section 12(d)(1)(C) of the 1940 Act limits the ability of any investment company (whether registered or not) to acquire more than 10% of the total outstanding voting stock of a BDC. However, the exemptive relief granted to date has also provided relief from this limitation.

12 *See* Investment Company Act of 1940 — Rule 12d12, Dechert LLP — Request for Interpretation under Rule 12d12, SEC No Action Letter, Division of Investment Management (Jan. 25, 2017).

13 *See* Fund of Funds Investments, Investment Company Act Release No. 27399 (June 20, 2006) ("Fund of Funds Investments Release"), available at: http://www.sec.gov/rules/final/2006/33-8713.pdf.

Since the issuance of the Fund of Funds Investments Release, various industry participants have recommended that the SEC remove or amend the AFFE disclosure requirement with respect to BDCs for two main reasons. First, much like real estate investment trusts (REITs) and regional/commercial banks, BDCs are not passive investment companies. Second, the AFFE disclosure requirement results in overstated expense ratios because an acquiring fund's indirect expenses required to be included in the calculation of AFFE can often be significantly greater than the direct expenses and the expense ratios of BDCs can be extremely high. At this time, it is not clear whether the SEC will take any action regarding the AFEE disclosure requirement with respect to BDCs.

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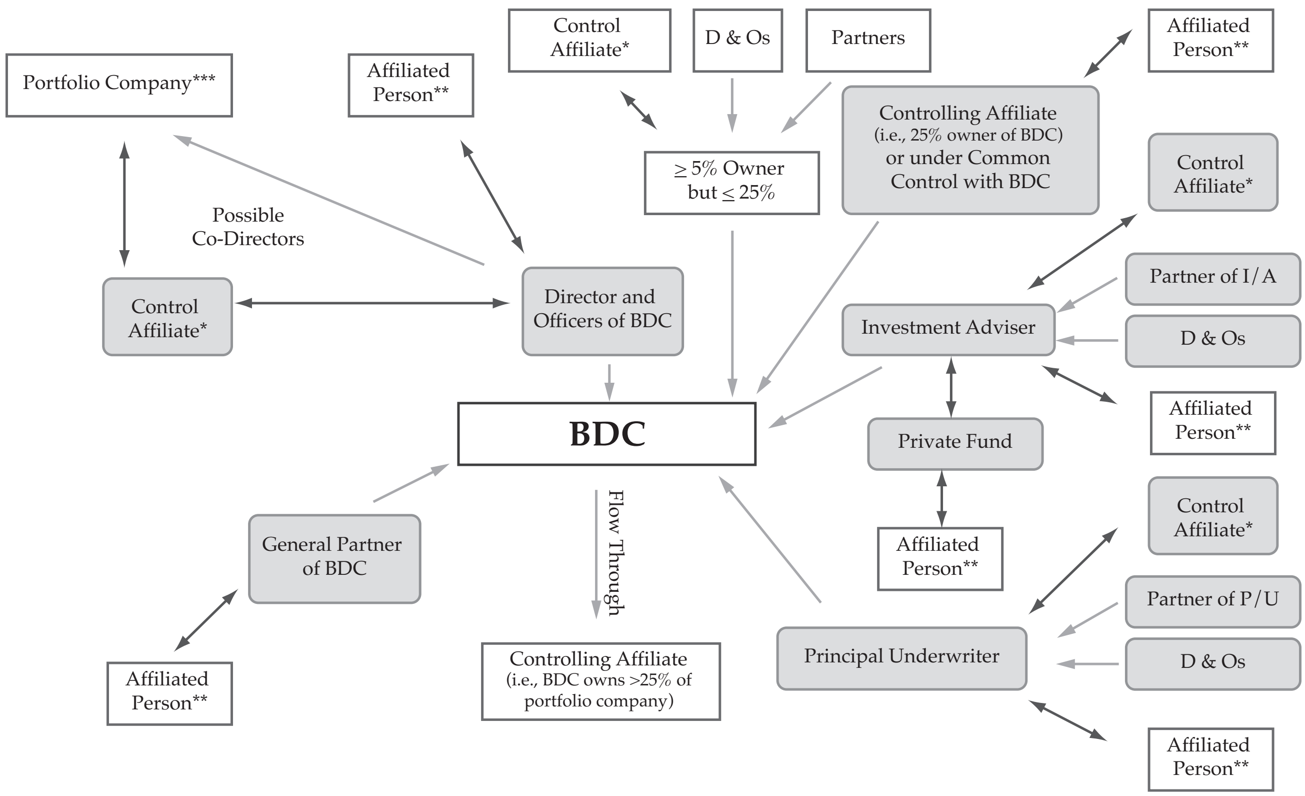
Exhibit A



Shaded Entities = First Tier Affiliates (SEC Approval Required)
Unshaded Entities =Second Tier Affiliates (Board Approval Required)

= One way affiliation
= Two way affiliation

* Any person that controls (i.e., >25% owner), is controlled by (*i.e.*, >25% owned), or is under common control with the other person.

** Any person that owns at least 5%, but not more than 25%of the other person.

*** No approval required if only relationship is with a common director.

Exhibit B

Proposed Transaction	Result Under Section 57 of the 1940 Act
Sale by a 25% shareholder of a BDC of securities of Company A to the BDC	Prohibited without prior SEC approval
Simultaneous investment by a BDC and a general partner of the BDC in Company A	Prohibited without prior SEC approval
Sale by a director, officer or employee of a BDC of securities of Company A to the BDC	Prohibited without prior SEC approval
Joint venture between a controlling interestholder in the BDC and a portfolio company	Prohibited without prior SEC approval *if* the portfolio company is a controlled affiliated of the BDC; otherwise permissible
Simultaneous investment by a BDC and a 5% shareholder of the BDC in Company A	Permissible with prior approval of the BDC's independent directors
Sale by a BDC of securities of Company A to a 5% shareholder of the BDC's investment adviser	Permissible with prior approval of the BDC's independent directors
Sale by a 5% shareholder of a BDC of securities of Company A to Company B, 25% of which is owned by the BDC	Permissible with prior approval of the BDC's independent directors
Simultaneous investment by a BDC and a limited partner of a private fund (under common control with the BDC by the BDC's investment adviser), who also owns 5% or more (but 25% or less) of the private fund's outstanding voting securities	Permissible with prior approval of the BDC's independent directors
Loan by a BDC to a company which is 50% owned by the BDC*	Not Prohibited
Acquisition by a BDC of securities of Company A, which is 25% owned by the BDC, from a director and 10% shareholder of Company A*	Not Prohibited
Follow-on investment by a BDC in an existing portfolio company	Not Prohibited
Sale by a BDC officer of securities of Company A, 5% of which is owned by the BDC, to Company A	Not Prohibited

* Provided that the portfolio company (or director) does not own 5% of the BDC, and is not an affiliated person of a director, officer, employee, principal underwriter, a general partner of, or any person controlling (25% owner) the BDC.