Business Development Company (BDC) Structuring and Trends
Agenda

- What is a Business Development Company?
- Structuring Considerations
- Use of Leverage
- Composition of BDC Portfolio
- BDC M&A Activity
- Additional Information
What is a Business Development Company?

- Congressional intent to provide venture capital through a public vehicle
  - Generally provides capital to small and middle market companies
  - Must offer managerial assistance to portfolio companies

- Closed-end fund
  - Legal status: investment company that elects to be treated as a BDC under the Investment Company Act of 1940
    - A BDC is not registered under the Investment Company Act
  - Subject to specialized SEC regulation as a BDC
    - Many provisions of the Investment Company Act apply to BDCs
    - Must have majority independent directors
  - More flexible structure than would be available to a traditional closed-end fund registered under the Investment Company Act
    - Increased ability to use leverage
    - Increased ability to issue shares for less than net asset value per share
    - Some flexibility to engage in transactions with certain “remote” affiliates without SEC exemptive order

- Subject to examination by the same SEC staff that examines registered funds
What is a Business Development Company? (Cont.)

- BDCs use closed-end fund registration statement form (Form N-2)
- Broader, more “retail” category of investors than for 3(c)(1) or 3(c)(7) funds
  - 1933 Act registered offering allows for true “retail” investors
  - Private offering can target accredited investors and is not limited to qualified purchasers
- No limit on number of holders
- Exchange Act reporting requirements apply: 10-Ks, 10-Qs, 8-Ks and proxy statements
- Investors must make Section 13 filings (5% (13F) or 20% (13G) holders) and Section 16 filings (10% holders); short swing profit rule applies to Section 16 filers
- Sarbanes-Oxley Act of 2002 requirements apply as though BDC were a public operating company
- Valuation
  - Mark-to-market – investments reported quarterly at fair value (ASC Topic 820)
    - Most BDC investments classified as level 3
  - Board responsible for valuation
    - Although not required, common to use third party valuation firm for periodic valuation of assets
- Significant limitations on transactions with affiliates
“Flow-Through” Tax Treatment as a RIC (optional, but generally elected)
- No corporate-level federal income tax on ordinary income or capital gains distributed to shareholders
- Diversification requirements tested as of the end of each quarter
  - Must be “diversified” as to 50% of assets – that is, as to 50% of the BDC’s portfolio, securities of any one issuer (other than cash, cash equivalents, US Government securities and securities of other RICs) may not represent more than 5% of the value of BDC’s assets or more than 10% of the outstanding voting securities of the issuer
  - No more than 25% of BDC’s assets may be invested in a single issuer, with certain exceptions
  - Taken together, a BDC must have at least 12 investments when fully invested
    - As a practical matter, the minimum number of investments is closer to 20
“Flow-Through” Tax Treatment as a RIC (Cont.)

Source of income requirements

- 90% of gross income must be derived from dividends, interest, payments with respect to certain loans of securities, gains from the sale of stock or other securities, or other income with respect to the business of investing in such stock or securities
  - Treatment of structuring and other fees
  - Equity investments in pass-through entities
  - Consulting income

Must annually distribute at least 90% of ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any

- Certain amounts must be distributed before the end of the calendar year to avoid 4% excise tax on certain undistributed income
- Investments in original issue discount and/or accreting securities can strain cash available for distribution in complying with RIC requirements
“Flow-Through” Tax Treatment as a RIC (Cont.)

- RIC will also generally distribute long-term capital gains to shareholders each year. Otherwise, these amounts are taxed at the corporate level.

- Character of dividends based on character of BDC’s income
  - U.S. shareholders: preferential tax rates on BDC dividends sourced from qualified dividend income and long-term capital gains
  - Non-U.S. shareholders: no withholding tax on long-term capital gain dividends, short-term capital gain dividends and interest-related dividends

- Considerations during ramp up
  - BDC may initially be taxable as a C Corporation or partnership
Structuring Considerations
Traded vs. Non-Traded BDCs

- **Traded BDC**
  - Shares of BDC offered through IPO with concurrent listing on exchange
  - Indefinite lifespan

- **Non-Traded BDC**
  - “Classic” Non-Traded BDC
    - Continuous public offering, generally up to a preset amount
    - Liquidity through periodic repurchase offers with potential to list on exchange or conduct other liquidity event within 5-7 year period
    - State “blue sky” considerations
  - “Private” BDC
    - Shares offered through private placement
    - Drawdown structure
    - May have no early liquidity or limited liquidity through periodic repurchase offers with potential to list on exchange or conduct other liquidity event within 5-7 year period

- **ERISA Considerations:** In general, plan assets regulation applies (i.e., benefit plan investors are limited to less than 25%) until a BDC’s stock is “publicly-offered security”
  - Among other things, a “publicly-offered security” must be “widely-held” (i.e., owned by 100 or more investors independent of the issuer and one another)
Structuring Considerations
Indicative Non-Traded, Private BDC Structure

- **Form of Entity**: Delaware LLC or Maryland Corporation
- **Offering**: Commitment-based private placement
- **Offering Period**: 1-2 years
- **Drawdown Period**: 3 years from end of Offering Period
- **Liquidity**:
  - No pre-IPO liquidity or tender offers for 2.5-5% of outstanding shares per quarter following Offering Period
  - Liquidation if no liquidity event (IPO, M&A) prior to end of Drawdown Period (subject to 1-2 year extension)
- **Management Fee**: 0.75-1.25% pre-IPO; 1.5-2.0% post-IPO
- **Incentive Fee**:
  - On Income: 10-15% pre-IPO; 20% post-IPO; 6-8% hurdle
  - On Capital Gains: 10-15% pre-IPO; 20% post-IPO
    - Advisers Act Section 205 imposes certain limits on this type of fee
A private BDC may be a corporation or partnership

- Typically used to block trade or business income for foreign investors and unrelated business taxable income for exempt investors, so most private BDCs typically elect RIC status.
  - Exemption on withholding for distributions of interest-related, short-term capital gain, and long-term capital gain.
- Would typically not operate as a C corporation (except possibly during ramp up).
- If intended to be a partnership, publicly traded partnership status must be monitored (and cannot be avoided by reliance on the good income test).
Structuring Considerations
Federal Income Tax Treatment of Non-Traded BDCs

- Private BDCs are sometimes the survivor of private fund conversions
  - Consideration should be given to whether carryover or stepped up basis is desirable, including the relevance of Section 721(b), the loss importation rules in respect of offshore fund conversions and Section 337(d) in respect of gain importation from C corporations.

- Private BDCs are often subject to Section 67(c), which limits individual investors’ deduction of BDC expenses. Consideration might be given to whether Section 67(c) might be avoided on the basis of the BDC’s business activity.

- Timing of BDC election must be carefully monitored to allow BDC to qualify as RIC.
Structuring Considerations
Internal vs External Management

- Internally managed BDCs can have option plan or profit-sharing plan
  - Stock options limited to 20% of total shares on a fully diluted basis
    - Options for independent directors require SEC order
    - Profit-sharing plan limited to 20% of net income after taxes in any fiscal year
- Externally managed BDCs may be charged both an asset-based advisory fee and a performance-based fee
  - Cannot vary management fees for investors (e.g., side letters or share classes)
    - Different BDC-level sales loads possible through feeders or potential SEC relief
  - Limitations on performance-based compensation
    - Any fee based on capital gains or capital appreciation is limited to 20% of realized capital gains, computed net of realized capital losses and unrealized capital depreciation
- BDCs generally have a two-part performance fee
  - Fee based on net capital gains
  - Fee based on net income over a hurdle
  - Certain recent BDCs have adopted a 20% overall cap on profit participation
Use of Leverage

- BDC may elect 150% asset coverage for debt and preferred stock issuances
  - Prior to enactment of Small Business Credit Availability Act in March 2018, all BDCs were required to have asset coverage of at least 200%
  - Newly launched BDCs may elect 150% asset coverage ratio from inception
  - Existing BDCs (pre-March 2018) seeking to lower requirement from 200% to 150% require either (i) approval by shareholders (effective on the next day following approval) or (ii) approval by “required majority” of board (effective one year following approval)
    - Unlisted BDCs must offer to repurchase shares in addition to approval
- Credit provider overlay
  - “Asset coverage” generally means the ratio of total assets of the BDC to the aggregate amount of outstanding debt and preferred stock of the BDC
  - Senior securities
- New Section 163(j) should be considered but should have little impact on interest deductibility by a BDC focused on debt investing.
Composition of BDC Portfolio

- A BDC must be operated for the purpose of investing in eligible portfolio companies and (with certain exceptions) offer to make available to such companies significant managerial assistance.

- A BDC may not purchase any “non-qualifying assets” unless, at the time of purchase, at least 70% of its total assets consists of qualifying assets (other than operating assets).
  - Qualifying assets (other than operating assets) include interests in *eligible portfolio companies*, cash and U.S. Government securities.
    - Total assets based on most recent financial statements filed by the BDC with the SEC.
    - Non-U.S. companies are included within the 30% Bucket.

- 1940 Act diversification requirements are separate and apart from RIC diversification requirements.
Generally, an “eligible portfolio company” is

- A U.S. company (organized and principal place of business)
- With an equity market capitalization of less than $250 million
- That is not an investment company or excepted from the definition of investment company pursuant to Section 3(c) of the Investment Company Act
  - Generally speaking, financial services companies such as banks, insurance companies, underwriters, broker-dealers, mortgage lenders (i.e., that hold interests in mortgages) and REITs (other than REITs that invest in physical real estate) would not be eligible portfolio companies, as they typically rely on an exclusion from the definition of investment company under Section 3(c) of the Investment Company Act
- Whose securities are purchased in a private transaction
- Must make available significant managerial assistance
Composition of BDC Portfolio

- BDCs were originally conceived of as publicly traded private equity funds.
  - Original BDCs were heavily focused on equity investments
  - Difficult to satisfy RIC asset-diversification rules
  - RIC distribution requirements limit growth
- Most BDCs generally focus on direct lending to portfolio companies and include senior loans, middle market 1st and 2nd lien loans, mezzanine debt, and unitranche debt
  - May also invest in syndicated loans, CLO debt and preferred and common equity
  - Often receive warrants or other equity kickers
  - Sometimes make both debt and equity investments in the same portfolio company
Composition of BDC Portfolio

- Direct lending BDCs should consider potential issues related to their dealer status.
  - Section 475 requires dealers to mark to market securities not “identified” as held for investment.
  - While fees from investing (including direct lending) should be good income, fees from dealer activity is more questionable.
  - Loan origination should not result in dealer status if the BDC engages in no more than negligible sales of the originated loans, unless the BDC elects dealer status or, for purposes of 471, accounts for any security as inventory.
  - Negligible sales means sales of part or all of fewer than 60 debt instruments (regardless of how acquired) or total basis of sold instruments (regardless of how acquired) is less than 5 percent of total basis.
  - Because of the scope of the “negligible sales” rules, BDCs in the origination business commonly treat themselves as dealers and put in place a global identification except for loans designated as held for sale.
Composition of BDC Portfolio

- Investments in Partnerships and LLCs
  - Many small businesses are organized as partnerships or other entities classified as partnerships for tax purposes
  - Equity investments in partnerships create significant issues for BDCs
    - Must look through to underlying source of income for gross income test
    - Application of asset-diversification tests uncertain
    - Penny warrants and other options may be characterized as current interests in a partnership
  - Loans to partnerships do not generally create special RIC issues
    - Workouts involving debt for equity exchanges may create problems
  - BDCs typically block bad income investments and monitor those for purposes of RIC diversification
    - Blockers are not good assets for purposes of the 50% diversification test
Composition of BDC Portfolio

- Investment through SBIC subsidiaries
  - Allows BDC to obtain funding from SBA
  - Generally structured as disregarded entities
    - Distribution limitations may apply
- Joint ventures
  - A number of BDCs own interests in a joint venture (often structured with an insurance company co-participant) that invests in more senior levels of a portfolio company than the BDC itself
    - Typically treated as a “non-qualifying” asset for 1940 Act purposes
    - Consider whether look-through is permitted for RIC diversification purposes
BDC M&A Activity

- Externalization transactions
  - Merger with an externally managed BDC
  - Distribution of management company?
  - Entering into a new advisory contract with an external advisor
- Inducement payments to shareholders to facilitate approval of new advisory contract
  - Generally structured as direct payment to shareholders from new advisor
  - Possible recharacterizations
    - Payment to acquiring company and boot to shareholders in connection with an acquisition
    - Payment to target company and distribution to shareholder
BDC M&A Activity

- Internalization transactions
  - Merger with an internally managed BDC
  - Acquisition of advisor
- Sale of advisor
  - What is being sold?
  - Advisory contract termination and approval
BDC M&A Activity

- Combination of BDCs
  - Generally structured as tax-free mergers
  - Plan for final dividend if necessary
- Combination of BDC and other closed-end funds
  - Principle issue is continuity of business enterprise
- Spin-off
  - Can BDC qualify as active business?
Additional Information
Structuring Considerations – General

- Distribution of Securities
  - BDCs are generally prohibited from selling their securities for
    - Services; or
    - Property other than cash or securities, except as a dividend or distribution to their security holders or in connection with a reorganization
  - Limitations on issuance of common shares at below net asset value (other than in the case of the IPO)
    - Requires board and shareholder approval (including a majority of non-affiliated shareholders)
      - Shareholder approval lasts for one year and must be re-approved at the next shareholder meeting
      - Only board approval is required in connection with an offering to the holders of one or more classes of the BDC’s capital stock (with certain additional conditions for transferable rights offerings)
    - Issue price must not be less than a price that closely approximates market value
    - Could affect ability to make subsequent offerings if shares trading below NAV post-listing
    - Implications for BDC reinvestment plans (DRIPs)
Generally, an “eligible portfolio company” is

- A U.S. company (organized and principal place of business)
- With an equity market capitalization of less than $250 million
- That is not an investment company or excepted from the definition of investment company pursuant to Section 3(c) of the Investment Company Act
  - Generally speaking, financial services companies such as banks, insurance companies, underwriters, broker-dealers, mortgage lenders (i.e., that hold interests in mortgages) and REITs (other than REITs that invest in physical real estate) would not be eligible portfolio companies, as they typically rely on an exclusion from the definition of investment company under Section 3(c) of the Investment Company Act
- Whose securities are purchased in a private transaction (see slide 31 for the complete definition of eligible portfolio company)

Typical investments generally focus on direct lending to portfolio companies and include senior loans, middle market 1st and 2nd lien loans, mezzanine debt, and unitranche debt

- May also invest in syndicated loans, CLO debt and preferred and common equity
Composition of BDC Portfolio Eligible Portfolio Company

- An eligible portfolio company must meet one of the following tests:
  - It has not issued a class of margin securities that is eligible for margin loans
  - It does not have any class of securities listed on a national securities exchange
  - It is a very small and solvent company ($4 million or less in total assets and not less than $2 million or less in capital and surplus)
  - It is controlled by a BDC or group of companies including a BDC and the BDC has a director on the board
  - It has a class of securities listed on a national securities exchange with a market capitalization (e.g., the aggregate market value of the company’s outstanding voting and non-voting common equity securities) of less than $250 million on any day within the 60-day period preceding the BDC’s acquisition of the portfolio company’s security
    - Market capitalization calculated using the price at which the company’s common equity is last sold, or the average of the bid and asked prices of the company’s common equity in the principal market of the common equity
Composition of BDC Portfolio Eligible Portfolio Company

- Making available significant managerial assistance means
  - Offering to provide, and providing if the offer is accepted, significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company; or
  - The exercise of a controlling influence over the management or policies of a portfolio company by the BDC acting individually or as part of a group acting together which controls such portfolio company
  - A BDC is not required to offer significant managerial assistance to companies with total assets of not more than $4 million and capital and surplus of not less than $2 million (Section 2(a)(47)) or to companies that are not “qualifying assets”
  - BDC may charge a fee for providing significant managerial assistance
- Only need to offer
  - In practice, it is unusual for a portfolio company to accept such offer
Composition of BDC Portfolio Qualifying Assets

- Qualifying Assets of a BDC
  - The following constitute qualifying assets for a BDC (Section 55(a) and Rule 55a-1):
    - Securities of eligible portfolio companies purchased in a private transaction from the issuer, an affiliate of the issuer (includes person that has been an affiliate within preceding 13 months) or from any other person, subject to such rules and regulations as the SEC may prescribe
    - Securities of a person that would otherwise be an eligible portfolio company except for the fact that it has a class of margin securities outstanding or a class of securities listed on a national securities exchange purchased in a private transaction from the issuer or an officer or employee of the issuer if
      - At the time of purchase the BDC owns at least 50% of
        - The greatest number of equity securities of the issuer and securities convertible into or exchangeable for such securities; and
        - The greatest amount of debt securities of the issuer, in each case held by the BDC at any point in time during which the issuer was an eligible portfolio company, and
      - The BDC is one of the 20 largest holders of record of the issuer’s outstanding voting securities
Qualifying Assets of a BDC (cont.)

- Securities of eligible portfolio companies that are controlled by the BDC and of which an affiliated person of the BDC is a director

- Securities of a company that would otherwise be an eligible portfolio company except for the fact that it has a class of margin securities outstanding if the company is bankrupt or distressed within the meaning of the Investment Company Act
  - Securities must be purchased in a private transaction
  - Except under limited circumstances, securities must be purchased from the issuer or an affiliate of the issuer
    - Securities may be purchased from a third party if, for example, the purchase is incident to a plan of reorganization
Qualifying Assets of a BDC (cont.)

- Securities of eligible portfolio companies acquired from any person when no public market for the securities exists if
  - Acquired in private transactions, and
  - Immediately prior to the acquisition, the BDC owned at least 60% of the outstanding equity securities of the portfolio company (on a fully diluted basis)

- Securities received in exchange for or distributed with respect to the foregoing securities (including securities obtained pursuant to the exercise of options, warrants or rights relating to such securities)

- Cash, cash items, U.S. Government securities or high quality debt securities maturing in one year or less from the time of investment

- Office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business operations of the BDC, deferred organization and operating expenses and other non-investment assets necessary and appropriate to its operations as a BDC
Restrictions on BDC owning, or being owned by, other funds (Section 12(d)(1))

- Other funds are limited in their ability to acquire shares of a BDC
  - A registered investment company or private fund may not acquire more than 3% of a BDC’s outstanding voting stock
  - Securities issued by the BDC cannot have an aggregate value of more than 5% of the value of an acquiring registered investment company’s total assets
  - Securities issued by the BDC and all other registered investment companies and BDCs owned by an acquiring registered investment company cannot have a value in excess of 10% of such acquiring registered investment company’s total assets
  - In addition, a registered fund may not acquire any security issued by a BDC if, immediately after the acquisition, the registered fund and other registered funds with the same investment adviser own more than 10% of the outstanding voting stock of the BDC

- BDC subject to same limitations on its ability to own other registered funds (certain rules permit investments in money market mutual funds in excess of these restrictions)
Composition of BDC Portfolio
Section 12

- Restrictions on buying securities of companies engaged in securities related activities (*Section 12(d)(3)*)
  - BDCs are generally prohibited from acquiring securities issued by broker-dealers, underwriters, investment advisers of investment companies or registered investment advisers (unless the company after the acquisition will be wholly owned by one or more BDCs or registered investment companies and the company is primarily engaged in the business of underwriting and distributing securities issued by other persons)
Restrictions on buying securities of companies engaged in securities related activities \((\text{Section 12(d)(3)})\) (Cont.)

Notwithstanding the foregoing, BDCs can acquire securities from issuers engaged in “securities related activities” if, in their most recent fiscal year, they

1. derive 15% or less of their gross revenues from such activities (unless the BDC would control the issuer after the acquisition)

2. derive more than 15% of their gross revenues from such activities, provided that:
   - immediately after the acquisition of any equity security, the BDC does not own > 5% of the outstanding securities of that class of the issuer’s equity securities;
   - immediately after the acquisition of any debt security, the BDC does not own > 10% of the outstanding principal amount of the issuer’s debt securities; and
   - immediately after the acquisition, the BDC has not invested > 5% of its total assets in the issuer’s securities

3. Note: The foregoing exemptions do not apply to acquisitions of general partner interests, securities issued by the BDC’s promoter or principal underwriter (or their affiliate) or securities issued by the BDC’s adviser (or its affiliate)
Composition of BDC Portfolio
Section 12

- Restrictions on buying securities of companies engaged in securities related activities *(Section 12(d)(3)) (Cont.)*
  - For purposes of the foregoing exemption:
    - "Securities Related Activities" generally means a person’s activities as a broker, dealer, underwriter or investment adviser
    - Calculation of gross revenues includes ratable share of the securities related activities of 20% or more owned entities
Affiliated Transactions

- Section 57 of the Investment Company Act limits transactions between a BDC and most affiliates (includes principal underwriters during distribution)
  - Limits principal transactions between BDC and its affiliates
  - Limits “joint transactions” involving BDC and its affiliates
  - Limits payments to affiliates for acting as agent
  - Limits ability of affiliate to borrow money or other property from a BDC
- Section 57 also limits transactions with an affiliate acting in an agent capacity
- BDCs can generally avail themselves of the existing exemptive rules as well as no-action letters applicable to registered funds that address certain affiliated transactions
- Unlike private funds subject only to the Investment Advisers Act (which can generally solve conflicts through disclosure and/or consent), certain transactions between a BDC and an affiliate may be simply prohibited under the Investment Company Act, and availability of SEC exemptive relief is very limited
Affiliated Transactions
Close vs. Remote Affiliates

- Section 57 treats “close” affiliates differently than “remote” affiliates
  - Transactions with a “remote” affiliate that would otherwise be prohibited under Section 57 may be permitted subject to approval by the BDC’s independent directors

- “Close” affiliate generally applies to affiliates in positions of direct influence over the BDC such as directors, officers and employees of the BDC and the BDC’s investment adviser, as well as any persons controlling, controlled by or under common control with such persons (see slide 38 for more detail)
  - “Principal” and “joint” transactions generally prohibited

- “Remote” affiliate generally applies to affiliates in positions of less influence over the BDC such as persons who hold 5% of the BDC’s voting securities or affiliated persons of such holders (see slide 39 for more detail)
  - Independent board approval based on a determination that the terms of the transaction are reasonable and fair to the BDC’s shareholders and don’t involve overreaching of the BDC or its shareholders
Affiliated Transactions
Close vs. Remote Affiliates

- “Close” affiliate means
  - Any director, officer, employee, or member of an advisory board of a BDC or any person (other than the BDC itself) who is an affiliated person of any of the foregoing persons by virtue of directly or indirectly controlling, being controlled by, or being under common control with, such other person.
  - Any investment adviser or promoter of, general partner in, principal underwriter for, or person that directly or indirectly either controls, is controlled by or is under common control with, a BDC (except the BDC itself and any person who, if it were not directly or indirectly controlled by the BDC, would not be directly or indirectly under the control of a person who controls the BDC), or any person who is an affiliated person of any of the foregoing persons by virtue of directly or indirectly controlling, being controlling by or being under common control with, or being an officer, director, partner, copartner or employee of, such other person.
    - This includes a subadviser to a BDC, and a person directly or indirectly in control of, controlled by, or under common control with, the subadviser.
“Remote” affiliate means

- Any person (a) who is, by virtue of owning 5% or more of the voting securities of the BDC, an affiliated person of a BDC, (b) who is an executive officer or a director of, or general partner in, any such affiliated person, or (c) who directly or indirectly either controls, is controlled by, or is under common control with, any such affiliated person.

- Any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promotor of, principal underwriter for, general partner in, or an affiliated person of any person directly or indirectly either controlling or under common control with a BDC (except the BDC itself and any person who, if it were not directly or indirectly controlled by the BDC, would not be directly or indirectly under the control of a person who controls the BDC).
Section 57: Principal Transactions

- Unlawful for any “Close Affiliate” of a BDC or any “Remote Affiliate” of a BDC (without board approval) acting as principal
  - Knowingly to sell any security or other property to the BDC (except in certain narrow cases);
  - Knowingly to purchase from the BDC any security or other property (except securities of which the seller is the issuer); or
  - To borrow money or other property from the BDC (except under limited circumstances permitted under the Investment Company Act)

- BDC and affiliate are across the table from one another
Affiliated Transactions (Cont.)

- **Section 57: Joint Transactions**

  - Section 57 limits a Close Affiliate of a BDC, or a Remote Affiliate of a BDC (without board approval), from knowingly effecting any transaction in which such BDC is a joint or a joint and several participant with such person in contravention of such regulations as the SEC may prescribe for the purpose of limiting or preventing participation by such BDC on a basis less advantageous than that of such person.
Affiliated Transactions
Joint Transactions

- Section 57 incorporates Rule 17d-1, which provides that no Close Affiliate of a BDC and no Remote Affiliate of a BDC (without board approval), acting as principal, may participate in, or effect any transaction in connection with, any joint enterprise or other joint arrangement or profit-sharing plan in which such BDC is a participant without SEC approval.
  - “Joint enterprise or other joint arrangement or profit-sharing plan” means any written or oral plan, contract, authorization or arrangement, or any practice or understanding concerning an enterprise or undertaking whereby a BDC and any affiliated person of such BDC, or any affiliated person of such a person, have a joint or joint and several participation, or share in the profits of such enterprise or undertaking.
- Evaluating whether a particular transaction is “joint” is very much a facts and circumstances analysis.
  - There is limited SEC guidance in this area.
- BDC and affiliate are on the same side of the table.
Affiliated Transactions
Co-Investment

- Is the co-investment “joint”?
  - Need the requisite element of combination or profit motive
- Publicly traded investments, no negotiation (SMC Capital No-Action Letter)
- Publicly traded instruments or private placements, only price is negotiated (Mass Mutual No-Action Letter)
  - SEC staff has taken the position that co-investments involving negotiation of terms more than just price may be considered “joint” where the investment adviser or other affiliate has:
    - A material pecuniary incentive; and
    - The ability to cause the BDC to participate with it in an aggregated transaction
  - There is no formal guidance on all of the terms that may constitute “price” in this context

- Rule 17d-1(d)(6) Exemption for Certain Restructurings
- SEC Co-Investment Exemptive Orders
Affiliated Transactions
Co-Investment (Cont.)

- Restructuring Exemption (Rule 17d-1(d)(6) under the Investment Company Act)
  - Provides an exemption for a BDC to participate in an otherwise prohibited joint transaction with an affiliate in the context of a “plan of reorganization”
  - What is a “plan of reorganization”?
    - Investment Company Act definition of “reorganization” is broader than the concept under the Bankruptcy Code. Includes:
      - Recapitalizations
      - Exchange of securities for outstanding securities
  - An adviser’s clients must own securities only in the same class or classes as the adviser’s BDCs or registered funds
  - All of the adviser’s clients must receive the same securities (subject to the same terms) and/or cash in the same proportion based on ownership percentages
Affiliated Transactions
Co-Investment (Cont.)

- SEC Co-Investment Exemptive Orders
  - Permits other funds and/or accounts advised by the BDC’s investment adviser to participate in a co-investment program with the BDC (where co-investment transactions would not otherwise be permitted), subject to certain conditions
  - Conditions include, but are not limited to, the following:
    - Adviser must independently determine appropriateness for BDC of any potential co-investment transaction that falls within the BDC’s objectives and strategies
    - BDC board, including a majority of its independent directors, must make certain findings with respect to each investment
    - Terms must be the same for each participating fund in a co-investment transaction
    - Transaction fees (e.g., breakup or commitment fees) must be distributed pro rata to the BDC and the adviser’s other clients who participated in the transaction
    - Quarterly reporting to the BDC board of all potential co-investments that were not made available to the BDC
  - Timing is 6-18 months for “plain vanilla” order
Affiliated Transactions
Co-Investment (Cont.)

- SEC Co-Investment Exemptive Orders (cont.)
  - Certain orders permit proprietary accounts of the adviser and its affiliates to participate in co-investment transactions under the order
    - Most of these orders require that any proprietary account participate only if there is excess capacity (i.e., after capacity has been sufficiently allocated to the BDC(s) and affiliated private funds that desire to participate)
    - Two recent orders granted to MassMutual and AXA Equitable do not contain this condition – perhaps due to particular circumstances of applicants as insurance company general accounts subject to additional oversight and restrictions under state insurance laws
Affiliated Transactions
Co-Investment (Cont.)

- Selected Issues under Co-Investment Exemptive Orders
  - Identifying scope of investments covered by Order
  - Pre-existing investments
    - Other than follow-on investments, a BDC is generally not permitted to invest under the Order where an affiliate of the BDC (which would include the BDC’s adviser and private funds under common control with the BDC) has an existing investment
      - Pre-existing investment or re-financing?
      - Original investment not made under the Order (e.g., Mass Mutual)
  - Balance sheet co-investing
  - Ability of an affiliated fund that invested in a portfolio company after the BDC to rely on the Order for purposes of a negotiated exit
  - Challenges of “season and sell”
  - Role of independent directors
Affiliated Transactions
Agent Transactions

- Section 57(k) makes it unlawful for certain affiliates of a BDC:
  - Acting as agent, to accept from any source any compensation (other than a regular salary or wages from the BDC) for the purchase or sale of any property to or for such BDC, except in the course of such person’s business as an underwriter or broker; or
  - Acting as broker, in connection with the sale of securities to or by the BDC, to receive from any source remuneration which exceeds:
    - the usual and customary broker’s commission if the sale is effected on a securities exchange;
    - 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of securities; or
    - 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected
Affiliated Transactions
Agent Transactions (Cont.)

- Section 57(k) applies to:
  - Any affiliated person of the BDC;
  - Certain affiliated persons of a director, officer, employee, or member of an advisory board of a BDC;
  - Certain affiliated persons of any investment adviser of, general partner in, or person directly or indirectly either controlling, controlled by, or under common control with, the BDC; or
  - Any person who controls, is controlled by, or is under common control with, a person who owns, controls or holds with power to vote 5% or more of the BDC’s outstanding voting securities
Additional Investment Company Act Requirements

- Must file a formal election with the SEC (*Section 54(a)*)
  - Must have a class of equity securities registered under Section 12 of the Exchange Act, or
  - Must have filed a registration statement pursuant to Section 12 of the Exchange Act for a class of equity securities
  - Typical filing sequence, if publicly offered: Form 8-A (Exchange Act), Form N-54A (Investment Company Act), Form N-2 (Securities Act)
  - For private BDC, file Form 10 with SEC
    - Assume minimum 1-2 months to clear SEC comments (Form 10 automatically effective after 60 days)

- BDC must obtain shareholder approval if it changes its business so as not to be a business development company
  - SEC staff interprets this to require a BDC to obtain shareholder approval if more than 50% of its total assets are not invested in the types of securities designed to meet its business purpose within the earlier of (i) 2 years after completion of IPO and (ii) 2-½ years after commencement of IPO
  - Assets invested in cash, money market instruments and cash equivalents not considered invested in accordance with a BDC’s business purpose
Additional Investment Company Act Requirements

- BDC must have a chief compliance officer and compliance program under SEC rules relating to mutual funds (*Rule 38a-1*)

- Compliance program typically must address, among other things:
  - Code of Ethics
  - Trading practices and trading with affiliated persons
  - Accuracy of disclosures
  - Allocations and conflicts
  - Material non-public information
  - Valuation
  - Recordkeeping
This presentation is intended only as a general discussion of these issues. It is not complete and should not be regarded as legal advice.
Presenters