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Business Development Companies: An Alternative Capital Source

Evaluating and Using BDCs to Finance Business Ventures

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Thomas J. Friedmann, Partner, **Dechert**, Washington, D.C.

Cynthia M. Krus, Partner, **Sutherland Asbill & Brennan**, Washington, D.C.

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Tuesday, October 6, 2009

The conference begins at:

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Business Development Companies: An Alternative Capital Source

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October 6, 2009

Dechert LLP

What is a Business Development Company?

- Publicly offered and exchange-traded closed-end fund
  - Intended to provide capital to small and middle-market companies
  - Originally intended by Congress to provide venture capital through a publicly listed vehicle
  - Internal or external management
  - Must <u>offer</u> managerial assistance to portfolio companies
- Subject to specialized SEC regulation as a BDC
  - The Investment Company Act of 1940 (the "1940 Act") applies to BDCs (Sections 54-65 of the 1940 Act set forth the statutory framework, which then refers to other sections of the 1940 Act)
    - BDCs use closed-end fund registration statement form (Form N-2)
  - Subject to examination by the same SEC staff that examines registered funds
  - If externally managed, must have investment adviser registered under Investment Advisers Act
  - Corporate housekeeping subject generally to 1940 Act provisions (custodian, indemnity bond)
- More flexible structure than would be available to a traditional closed-end fund registered under Investment Company Act
  - May pay performance fees to adviser <u>or</u> options <u>or</u> profit-sharing compensation to management
  - Increased ability to use leverage (Section 61 of the 1940 Act (incorporating portions of Section 18)
  - Increased ability to issue shares for less than net asset value per share
  - Some flexibility to engage in transactions with certain affiliates without an SEC exemptive order

Potential Investment Focus of BDCs

Broad array of acceptable Investments:

- Mezzanine loans
- Senior loans
- Venture capital
- Private equity
- Subject to:
  - Regulatory limitations include the eligible portfolio company test
  - Income distribution requirements, if applicable, for a regulated investment company (or “RIC”) under the Internal Revenue Code tend to favor investments with current cash payments, such as mezzanine and senior debt

Potential Benefits of BDC Structure vs. Traditional Lenders and Private Funds

- BDCs not subject to regulatory limitations and capital requirements applicable to banks and other traditional lenders
  - Investments must be at least 70% in eligible portfolio companies (Section 55)
  - Capital structure limited (Section 61)
- Access to public markets to raise initial or follow-on capital, unlike private funds
  - Underwriting discount and timing of offering similar to IPO
  - IPO results in exchange-listed security
  - Limitation on issuance of common stock at a price below net asset value (Sections 63, 23(b))
- Perpetual life
  - Permanent equity capital affords longer investment horizon than traditional private funds

Regulatory Scheme Applicable to BDCs: A Hybrid Approach

- Securities Exchange Act of 1934 reporting requirements apply – 10-Ks, 10-Q, 8-Ks and proxy statements
- Sarbanes-Oxley Act of 2002 requirements apply as though BDC were a public operating company
- Single level tax treatment as a RIC under Internal Revenue Code (optional election)

Ongoing BDC Operating Requirements – Periodic Reporting Requirements

- Annual Report on Form 10K
  - Must comply with requirements of Regulation S-K under the Securities Act
  - Also should comply with applicable Form N-2 requirements
    - Description of portfolio companies > 5 percent
    - Description of portfolio managers and investment process
    - Makes disclosure in Form 10K consistent with capital raising prospectus
- Quarterly Report on Form 10Q
  - Include Regulation S-K disclosures and applicable 1940 Act requirements
  - Coordinate financial statements, NAV calculation and RIC compliance tests
- Reports on Form 8-K as warranted
- No incorporation by reference

Ongoing BDC Operating Requirements – Valuation

- Calculation of NAV quarterly (do not hold primarily marketable securities)
- NAV and individual valuations marked-to-market under FAS 157; typically Category 3 securities
- Most BDCs use three-step valuation methodology
  - Management valuation of portfolio company securities
  - External valuation firm provides independent calculation
  - Board reviews and adopts final valuation
  - Independent audit firm reviews valuations and may suggest modifications

Ongoing BDC Operating Requirements – Limitation on Leverage

- Minimum 200% asset coverage required for borrowing or issuance of debt securities (50% debt-to-total capitalization)
- Incurrence test: implications of mark-to-market valuation

Ongoing BDC Operating Requirements – Capital Raising

- Offerings of Common Stock below NAV
  - Board and stockholder approval required -- specific board determinations
  - Issue price cannot be less than secondary market value
  - Rights offering option
- Issuance of debt and preferred stock subject to leverage test
- Warrants and options subject to limitations under Section 61
- Use of Form N-2; no incorporation by reference
- Availability of Shelf Registration

Ongoing BDC Operating Requirements – Corporate Governance/Compliance

- Board independence
- Full application of Sarbanes Oxley requirements
- Compliance under the 1940 Act
  - Annual approval process for investment advisory agreement
  - Chief compliance officer and compliance program -- emphasis on process
- Advisor and Administrator Roles

Ongoing BDC Operating Requirements – Tax: Compliance with RIC Qualifications

- "Flow-Through" Tax Treatment as a regulated investment company, or RIC
  - No corporate-level federal income tax on ordinary income or capital gains distributed to stockholders
- Source of income requirements
  - Fee income disfavored
  - 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
- Distributions
  - 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 create strain on cash distributions to comply with RIC requirements
  - Annual Test -- timing and amount of dividends
  - Implications of PIK Securities
  - Dividend Reinvestment Plans
  - Temporary relief from IRS -- payment of up to 90% of distributions using stock

Ongoing BDC Operating Requirements – Tax: Compliance with RIC Qualifications (cont.)

- RIC Diversification Test
  - 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
    - Result of these requirements, taken together, is that BDC must have at least 12 investments when fully invested (and probably more in most situations)
  - Five-year penalty for non-compliance

Ongoing BDC Operating Requirements – Anti-Pyramiding Rules

Restrictions on BDC owning, or being owned by, other funds

- Other funds are limited in their ability to acquire shares of BDC
  - A registered or private fund may not acquire more than 3% of a BDC's outstanding voting stock
  - 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 also limited in its ability to own other registered funds (e.g., money market mutual funds)

Principal 1940 Act Requirements

- BDC must obtain stockholder 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 stockholder 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 two years after completion of IPO or 2½ years after commencement of IPO

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October 6, 2009

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What is a Business Development Company?

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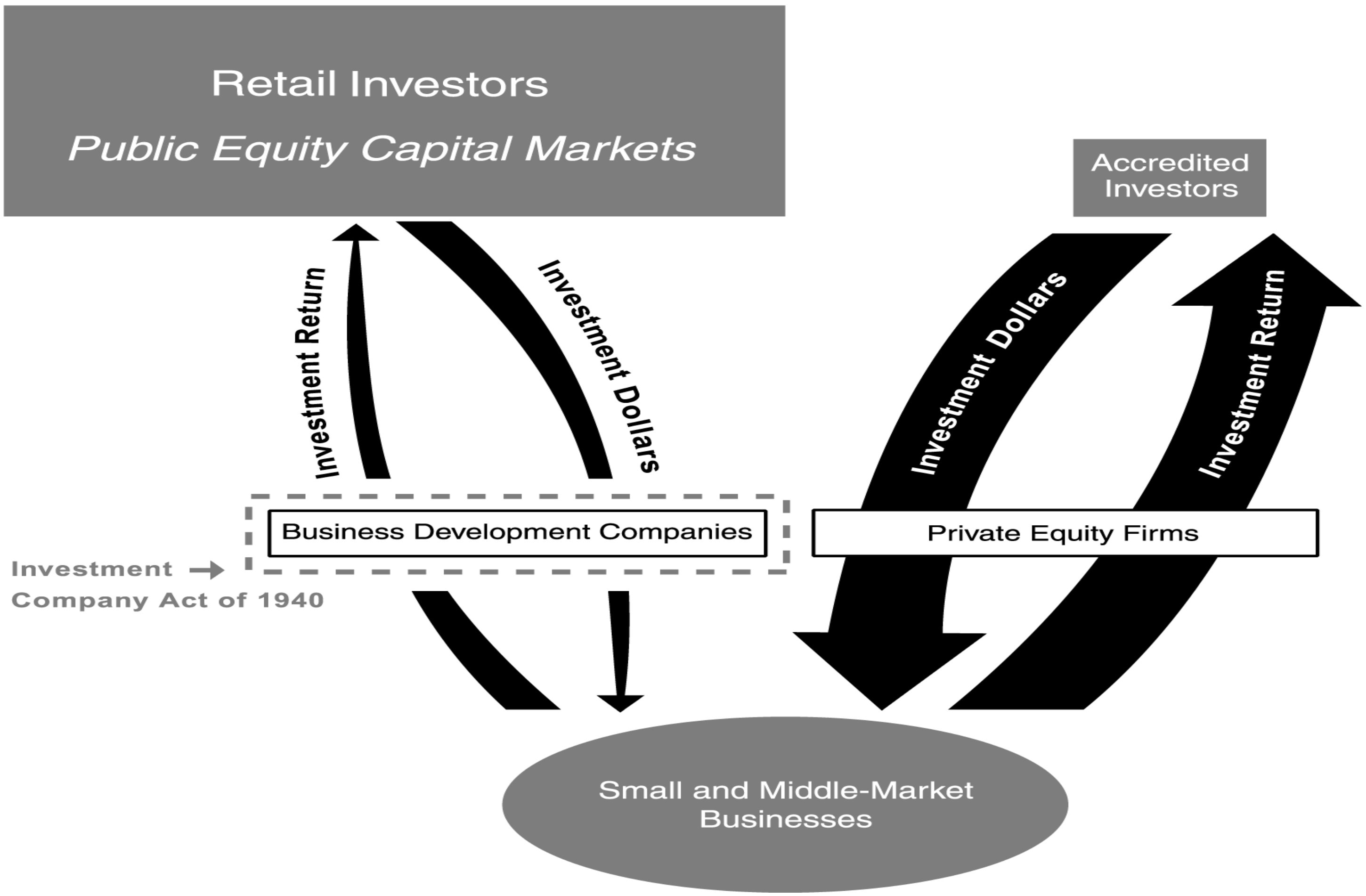
- Created by the Small Business Investment Incentive Act of 1980 (the "1980 Amendments") as a result of a perceived crisis in the capital markets in the 1970s. The crisis stemmed from private equity and venture capital firms that believed that their capacity to provide financing to small, growing businesses was limited by the requirements of the "small private investment company" exemption set forth in Section 3(c)(1) of the 1940 Act.
- At the time the 1980 Amendments were passed, Congress believed that BDCs would become a widely used investment vehicle. For example, the legislative history notes that:
  - Approximately 20 to 30 firms were expected to register as BDCs within the first year after the date of enactment; and
  - BDCs would be able to invest in approximately 2/3 of all public companies in addition to all private companies.

What is a Business Development Company?



What is a Business Development Company?

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- Publicly traded closed-end funds that:
  - Provide small, growing companies access to capital
  - Enable private equity funds to access the public capital markets
  - Enable retail investors to participate in the upside of pre-IPO investing with complete liquidity

- Hybrid between an operating company and an investment company

How did the BDC Industry Develop?

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- Prior to 2003, the largest BDCs were primarily internally-managed. This choice was a reflection of the success of the internally managed, income producing BDC model
- In the fall of 2003, Technology Investment Capital Corp. (TICC) successfully completed a $130 million IPO of shares of its common stock
- In April 2004, an affiliate of Apollo Capital Management, L.P. launched its own externally managed BDC, Apollo Investment Corporation (Apollo), through a $930 million IPO
- Within weeks of the closing of Apollo, approximately twelve funds had filed registration statements to form externally managed BDCs. Two BDCs completed their IPOs in 2004
- There has been a steady stream of BDC IPOs since that period, including Patriot Capital Funding, Inc., Hercules Technology Growth Capital, PennantPark Investment Corporation, and Fifth Street Finance Corp.

How did the Financial Crisis affect BDCs?

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- Declining stock price
- Declining net asset value
- Increase in unrealized depreciation
- Compliance with 200% asset coverage ratio
- Deleveraging and sale of assets
- Compliance with financial covenants in debt agreements
- Inability to access the capital markets
- Dividend payments
- Consolidation

What are some recent trends and developments for BDCs?

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Growing market presence

- Over 25 BDCs currently on NYSE, Nasdaq, AMEX, or OTCBB
- Nine IPOs from 2007 through August of 2009
  - Keating Capital, Inc. (06-11-09)
  - Fifth Street Finance Corp. (06-17-08)
  - Main Street Capital Corporation (10-4-07)
  - Blackrock Kelso Capital Corp. (6-27-07)
  - PennantPark Investment Corporation (4-19-07)
  - GSC Investment Corp. (3-23-07)
  - Highland Distresses Opportunities, Inc. (2-21-07)
  - Triangle Capital Corporation (2-14-07)
  - Tortoise Capital Resources Corp. (2-2-07)
- Pending IPOs
  - Solar Capital Ltd.
  - THL Credit, Inc.

What are some recent trends and developments for BDCs?

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BDC FOLLOW- ON OFFERINGS IN 2009*

	Equity
Apollo Investment Corporation	$ 173,000,000
Ares Capital Corporation	$ 109,600,000
Fifth Street Finance Corp.	$ 137,300,000
Main Street Capital Corporation	$ 16,300,000
PennantPark Investment Corporation	$ 32,500,000
Prospect Capital Corporation	$ 119,100,000
Triangle Capital Corporation	$ 14,600,000

**As of September, 2009*

There have been no debt offerings to date during 2009

What is the BDC industry's role in the current economy?

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- <u>Market Position</u>:
  - At the height of the market, BDCs had aggregate portfolio assets of approximately $27.5 billion invested in approximately 1,500 small and middle market companies across the United States.
  - Actively traded BDCS had approximately $21 billion in assets as of June 2009.
- <u>Contribution to Economy</u>:
  - It is estimated that the BDC industry in the aggregate currently sustains approximately 1.5 million U.S. jobs.
  - BDCs can play a significant role in the future success of middle market companies by providing a much needed source of financing.

Private Equity vs. Mezzanine model

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Growth-Focused	Growth-focused BDCs resemble pure venture capital enterprises that seek high returns on investment by investing in early development stage companies primarily through equity instruments. Their portfolio companies typically have a limited operating history and consequently investments in them involve a significant degree of speculation. However, the potential gains they offer are regarded as outweighing their inherent risks.
Value-Focused	Value-focused BDCs seek to achieve more moderate returns on investment than growth-focused BDCs by investing in companies with more established operations, which consequently entails less speculation.
Income Producing	Income-producing BDCs seek high current income and capital gains by making loans to later-stage companies with significant cash flow. As an added incentive to provide financing, income-producing BDCs generally receive warrants from their portfolio companies, which provide the BDC with potential for capital gains.

What is a Business Development Company?

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- Both internally and externally managed structures
- Closed-end investment fund subject to a “1940 Act Light” regulatory regime.
  - Lower asset coverage requirement
  - Ability to issue equity compensation (for internally managed) and to receive performance fees (externally managed)
  - Less extensive affiliated transaction prohibitions
  - Eligible for RIC tax treatment

How Do BDCs Differ from Registered Investment Companies?

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- BDCs are designed to accommodate private company investments
- Provide greater latitude in using leverage to enhance returns
- Allow issuance of options/incentive fees to incentivize management
- Allow certain joint transactions without requiring prior Commission approval
- Must have a board of directors a majority of whose members are not "interested persons"
- Require quarterly asset valuation

How Does a Company Become a BDC?

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- Make an election to be a BDC- file a Form N-54A (Notification of election to be subject to sections 55 through 65 of the 1940 Act)
- Register a class of securities under the 1934 Act
- Register a class of securities on Form N-2 under the 1940 Act
- List securities on the New York Stock Exchange (NYSE), the Nasdaq Stock Market, Inc. (Nasdaq), or the American Stock Exchange (AMEX), or the BDC can be a non-traded BDC
- Comply with the Sarbanes-Oxley Act of 2002

What are the Reporting Requirements?

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- Form 10-K (Annual Report)
- Form 10-Q (Quarterly Report)
- Form 8-K (Current Report)
- Proxy Statements
- Sections 13 and 16 Filings
  - Forms 3, 4 or 5 for reporting beneficial ownership by insiders
  - Schedules 13D and 13G for reporting beneficial ownership by others
- Regulation G and Regulation FD
- Comply with the Sarbanes-Oxley Act of 2002

What is the Difference Between Internally-Managed and Externally Managed BDCs?

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- An Internally Managed BDC
  - Does not have an investment adviser
  - Is managed by its executive officers under the supervision of its board of directors
  - Does not pay investment advisory fees but pays the operating costs associated with employing investment management professionals
  - Often uses equity-based compensation

- An Externally Managed BDC
  - Has an investment adviser
  - Pays investment advisory and incentive fees to its investment adviser fees

How Are a BDC's Assets Valued?

- Board of directors uses "fair value" accounting to value assets on a quarterly basis
  - Market value of assets for which market quotations are readily available
  - Fair value for other securities and assets
  - Each debt and equity security is separately valued

- There is no single standard for determining fair value in good faith

- Determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process

- FAS 157- requires that public companies' financial instruments generally be valued at their current market price (i.e., "mark to market")

What are the Regulatory Requirements?

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- BDCs must invest at least 70% of assets in “eligible portfolio companies”
- BDCs must make available significant managerial assistance to these companies
- BDCs must have 200% asset coverage (Total Assets/Total Debt).
  - Other investment companies are restricted to a 300% asset coverage requirement with respect to issuing debt
- The ability of BDCs to engage in transactions with affiliates- Section 57
- Internally vs. Externally- Managed BDCs
  - Internally managed- Does not pay investment advisory fees but pays the operating costs associated with employing investment management professionals
  - Externally managed- Pays investment advisory fees; pursuant to Section 205(b)(3) of the Advisers Act, pays incentive fees provided that the BDC does not have outstanding any equity-based compensation arrangement or profit-sharing plan

Launching and Ramping a BDC

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- Develop a business plan
- Choose the structure of BDC and the state of incorporation
- Determine blind pool vs. existing portfolio
- Determine lead underwriters
- Waiver of fees during ramp up
- SEC comment process

What are the Benefits of the BDC as an Investment Vehicle?

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- Access to public capital markets
- Shares are traded on exchanges or Nasdaq
- Flow-through tax treatment
- Reduced burden under 1940 Act
- External model permits management fee and "carried interest" incentive fee structure
- Publicly available financial information through quarterly reporting
- Portfolio is typically diversified which reduces risk to investors associated with private equity investments
- Restrictions on leverage/affiliated transactions

Business Development Companies: An Alternative Capital Source

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October 6, 2009

BDC Compensation

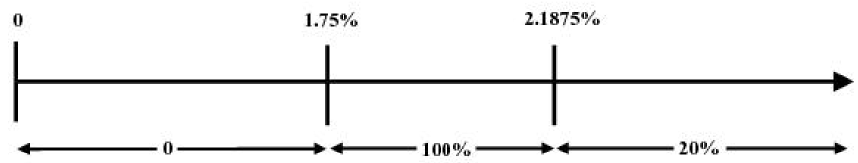
- BDCs have a significant advantage over traditional listed registered closed-end funds in fee structure
- If a BDC has an investment adviser, it may charge performance-based fee in addition to a base management fee
  - Listed closed-end funds cannot charge a performance-based fee
- If a BDC does not have an investment adviser, it can instead have an option plan <u>or</u> profit-sharing plan
  - Listed closed-end funds are effectively limited in their ability to issue options, rights or warrants or have a profit-sharing plan

Compensation – Externally Managed BDCs

- Management Fee
  - Annual rate based on the average value of "gross" assets, which includes leverage; may exclude cash
  - Typically ranges from 1.5% to 2.0%
- Performance or Incentive Fee
  - The Advisers Act generally limits ability of publicly listed investment vehicle to pay compensation based on performance
  - *Registered* investment adviser to a BDC can receive a performance fee notwithstanding the Advisers Act
  - Must be in lieu of an option plan or profit-sharing plan
  - Performance fee generally composed of two parts: an income component and a capital gains component
- Investment Company Act imposes a process for approval of advisory agreements

Compensation – Externally Managed BDCs
Income Component

- Income component based on *pre-incentive fee net investment income*, meaning interest income, dividend income and any other income (which may include other fees generated by the BDC but excludes fees for providing managerial assistance) accrued during the calendar quarter, minus operating expenses for the quarter (including the base management fee but excluding the incentive fee).
- Calculated separate and apart from the capital gains component
- Typically coupled with a hurdle rate with a catch-up, meaning no performance fee is paid on investment income until the rate of return on net assets exceeds a certain quarterly benchmark.



Compensation – Externally Managed BDCs Income Component (cont.)

- Example
  - Hurdle rate = 1.75%
  - Management fee = 0.375%
  - Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.20%
  - Investment income (including interest, dividends, fees, etc.) = 3.50%
- Pre-incentive fee net investment income (investment income - (management fee + other expenses)) = 2.925%
- Pre-incentive fee net investment income exceeds hurdle rate; therefore, there is an incentive fee.
- Incentive Fee = 100% "Catch-Up" + the greater of 0% and (20% x (pre-incentive fee net investment income - 2.1875%))

  = (100% x (2.1875% - 1.75%)) + (20% x (2.925% - 2.1875%))

  = 0.4375% + (20% x 0.7375%)

  = 0.4375% + 0.1475%

  = 0.585%

Compensation – Externally Managed BDCs Capital Gains Component

- Calculated at the end of each applicable year by subtracting (a) the sum of *cumulative aggregate realized capital losses* and *aggregate unrealized capital depreciation* from (b) *cumulative aggregate realized capital gains*.
- If such amount is positive at the end of such year, then the capital gains fee for such year is equal to the stated percentage of such amount, less the aggregate amount of the capital gains fees paid in all prior years.
- Under Section 205(b)(3) of the Advisers Act, the capital gains performance fee cannot exceed 20%

Compensation – Externally Managed BDCs Capital Gains Component (cont.)

- The *cumulative aggregate realized capital gains* are calculated as the sum of the differences, if positive, between (a) the net sales price of each investment in our portfolio when sold and (b) the accreted or amortized cost basis of such investment.
- The *cumulative aggregate realized capital losses* are calculated as the sum of the amounts by which (a) the net sales price of each investment in our portfolio when sold is less than (b) the accreted or amortized cost basis of such investment.
- The *aggregate unrealized capital depreciation* is calculated as the sum of the differences, if negative, between (a) the valuation of each investment in our portfolio as of the applicable capital gains fee calculation date and (b) the accreted or amortized cost basis of such investment.

Compensation – Externally Managed BDCs Capital Gains Component (cont.)

- Year 1: $20 million investment made in Company A (“Investment A”), $30 million investment made in Company B (“Investment B”) and $25 million investment made in Company C (“Investment C”)
- Year 2: Investment A sold for $50 million, FMV of Investment B determined to be $25 million and FMV of Investment C determined to be $25 million
- Year 3: FMV of Investment B determined to be $27 million and Investment C sold for $30 million
- Year 4: FMV of Investment B determined to be $35 million
- Year 5: Investment B sold for $20 million

Compensation – Externally Managed BDCs Capital Gains Component (cont.)

The capital gains portion of the incentive fee, if any, would be:

- Year 1: None (no sales transactions)
- Year 2: $5 million (20% multiplied by $25 million ($30 million realized capital gains on Investment A less $5 million unrealized capital depreciation on Investment B))
- Year 3: $1.4 million ($6.4 million (20% multiplied by $32 million ($35 million cumulative realized capital gains less $3 million unrealized capital depreciation)) less $5 million (capital gains fee paid in Year 2))
- Year 4: None (No sales transactions)
- Year 5: None ($5 million (20% multiplied by $25 million (cumulative realized capital gains of $35 million less realized capital losses of $10 million)) less $6.4 million (cumulative capital gains fee paid in Year 2 and Year 3))

Compensation – Internally Managed BDCs Stock Option Plan

- Under Section 61(a)(3)(B), a BDC may issue, to its directors, officers and employees, warrants, options, and rights pursuant to an executive compensation plan, if:
  - In the case of warrants, options, or rights issued to any officer or employee of a BDC, (1) such warrants, options, or rights expire by their terms within ten years, (2) 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 of such voting securities; and (3) the proposal is authorized by shareholders, and approved by the *required majority* of the directors of the BDC on the basis that such issuance is in the best interests of such company and its shareholders;
  - In the case of warrants, options, or rights issued to any director of a BDC who is not also an officer or employee of such company, the proposal, in addition to satisfying (1) and (2) above, must be authorized by the shareholders, and approved by the SEC on the basis that the terms of the proposal are fair and reasonable and do not involve overreaching of such company or its shareholders;
  - such securities are not transferable except for disposition by gift, will, or intestacy;
  - No investment adviser of the BDC receives any performance compensation; and
  - The BDC does not have a profit-sharing plan

Compensation – Internally Managed BDCs Profit Sharing Plan

- Section 57(n) of the Investment Company Act provides that a BDC may establish a profit-sharing plan for its directors, officers and employees if:
  - in the case of a plan for officers and employees of the BDC, such profit-sharing plan is approved by the *required majority* of the directors of such company on the basis that such plan (1) is reasonable and fair to the shareholders of such company, (2) does not involve overreaching of such company or its shareholders on the part of any person concerned, and (3) is consistent with the interests of the shareholders of such company; or
  - in the case of a plan which includes one or more directors of the BDC who are not also officers or employees of such company, such profit-sharing plan is approved by order of the SEC on the same three-prong basis set out above; and
- the aggregate amount of benefits paid or accrued under such plan may not exceed 20% the BDC's net income after taxes in any fiscal year.
- A BDC may not have a profit sharing plan if it (1) has outstanding any stock option, warrant, or right issued as part of an executive compensation plan or (2) has a registered investment adviser

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
- BDCs can generally avail themselves of the existing exemptive Rules as well as no-action letters applicable to registered funds generally that address affiliated transactions

Affiliated Transactions
Control vs. Remote Affiliates

- "Control" 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, by virtue of directly or indirectly controlling, controlled by or under common control with, an affiliated person of any of the foregoing persons
  - Any investment adviser or promoter of, general partner in, principal underwriter for, or person directly or indirectly either controlling, controlled by, 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), or any person who is, by virtue of directly or indirectly controlling, controlled by or under common control with, or an officer, director, partner, copartner or employee of, an affiliated person of any of the foregoing persons
- "Principal and "joint" transactions generally prohibited

Affiliated Transactions Control vs. Remote Affiliates

- "Remote" affiliate means
  - Any person (A) who is, by virtue of owning 5% or more of the voting securities, 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, such affiliated person.
  - Any person who is an affiliated person of a director, officer, employee, investment adviser, member of an advisory board or promoter 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).
- "Principal and "joint" transactions permitted with board approval

Affiliated Transactions
Principal Transactions

- Section 57 addresses an affiliate of a BDC
  - knowingly selling any security or other property to such BDC or to any company controlled by such BDC, unless such sale involves solely (A) securities of which the buyer is the issuer, or (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities
  - knowingly purchasing from such BDC or from any company controlled by such BDC, any security or other property (except securities of which the seller is the issuer)
- Addresses scenarios where the affiliate is on the other side of the table acting for its own interests
- Examples

Affiliated Transactions
Joint Transactions

- Section 57 limits an affiliated person of a BDC 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
- Section 57 incorporates Rule 17d-1, which provides that no affiliated person of any BDC and no affiliated person of such a person, 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 a joint and several participation, or share in the profits of such enterprise or undertaking

Affiliated Transactions
Joint Transactions

- Evaluating whether a particular transaction is "joint" is very much a facts and circumstances analysis
  - There is limited SEC guidance
- Addresses scenarios where the affiliate and BDC are on the same side of the table
- Co-investing with an affiliate
  - Is it "joint"?
  - Mass Mutual and SMC Capital
  - SEC orders
- Other joint transactions

Affiliated Transactions Agent Transactions

- Section 57(k) addresses an affiliate 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 such securities; or
    - 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected
- Section 57(k) applies to a broad category of affiliates

Potential Benefits of BDC Structure vs. Traditional Lenders and Private Funds

- Access to public markets to raise initial or follow-on capital, unlike most venture capital, private equity and mezzanine funds
  - Exchange-traded security
- Not subject to regulatory limitations and capital requirements applicable to banks and some other traditional lenders
  - Subject to specialized Investment Company Act provisions applicable to BDCs
- Perpetual life
  - Permanent equity capital affords longer investment horizon than traditional private funds
- Attractive fee structure as compared to registered closed-end fund

Challenges for New BDCs

- Immediate dilution to shareholders as a result of underwriters' commission
- Marketing issues
  - Excess supply
  - Limited eligible investments
  - High fees
  - Blind pool aspect
- Tax Implications of Investments by non-US Persons
- Public perception

This presentation is intended only as a general discussion of these issues. It is not complete and should not be regarded as legal advice.