

# **Business Development Companies: Forming, Financing and Investing in Alternative Capital Vehicles**

Best Practices for Issuers, Asset Managers and Investors

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THURSDAY, AUGUST 13, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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Cynthia Krus, Partner  
August 13, 2015

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# Business Development Companies: Forming, Financing and Investing in Alternative Capital Vehicles

The logo for Sutherland, consisting of a blue rectangular box with the word "SUTHERLAND" in white, uppercase, sans-serif font. Below the box is a thin, horizontal brown line.

SUTHERLAND

# Part I: Overview of the BDC Model

# Overview

- Created by Congress through 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.
- Private equity and venture capital firms believed the “small private investment company” exemption (Section 3(c)(1) of the 1940 Act) limited their capacity to provide financing to small, growing businesses.
- Provided Regulated Investment Company (RIC) tax status in 1990.
- Special type of closed-end fund that:
  - Provides small, growing companies access to capital
  - Enables private equity funds to access the public capital markets.
  - Enables retail investors to participate in the upside of pre-IPO investing with complete liquidity
- Hybrid between an operating company and an investment company

# Benefits of the BDC Model

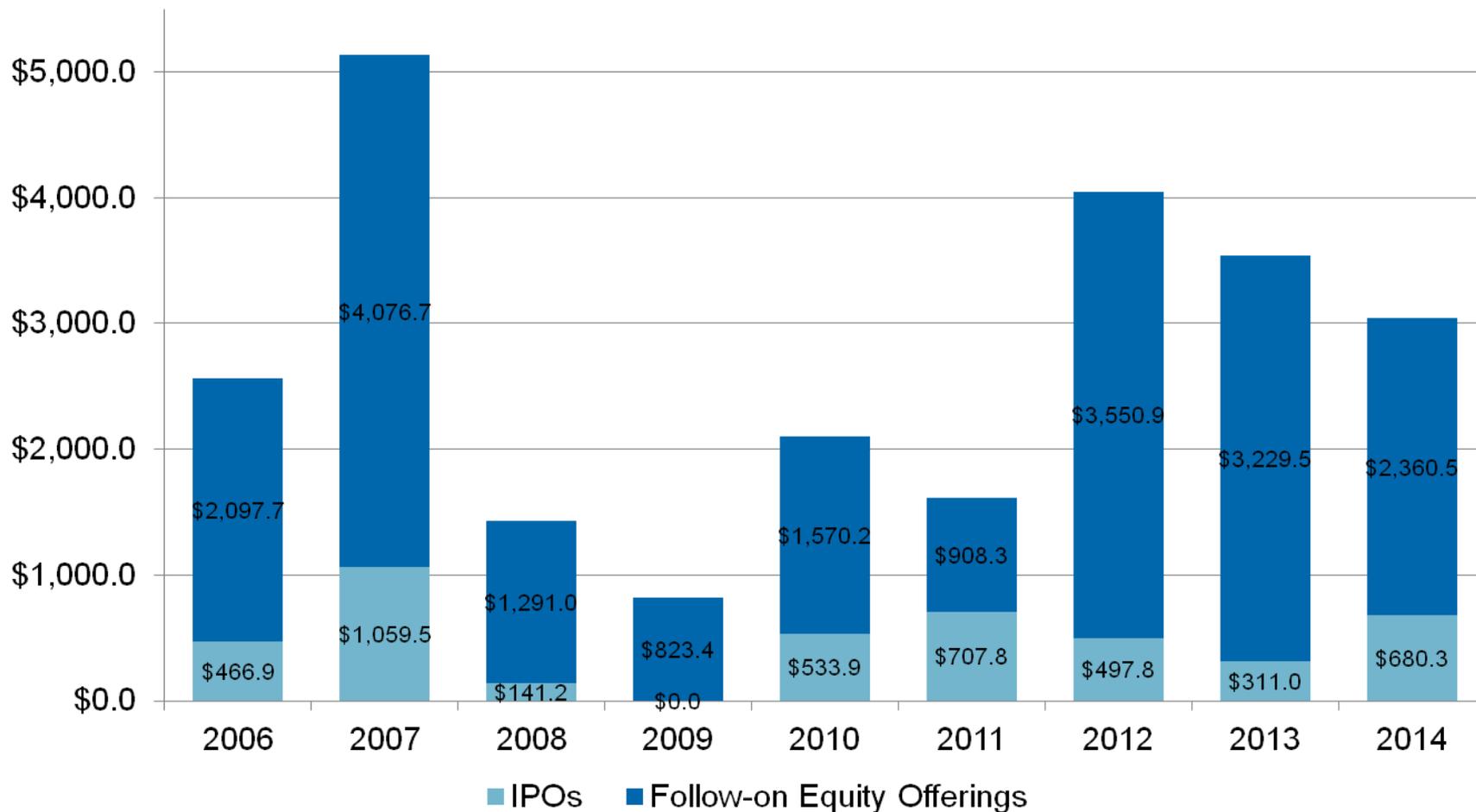
- Shares are traded on national exchanges
- Access to public capital markets and retail investors
- Reduced burden under 1940 Act, as compared to closed-end funds
  - Restrictions on leverage
  - Restrictions on affiliated transactions
- Publicly available financial information through quarterly reporting
- External model permits management fee and “carried interest” incentive fee structure
- Flow-through tax treatment as a RIC
- Portfolio is typically diversified under RIC requirements
  - Reduces risk typically associated with private equity investments

# How the BDC Market Developed

- Prior to 2003, the largest BDCs were primarily internally managed.
  - Choice reflected the success of the internally managed, income producing BDC model
- In 2004, Apollo Investment Corporation raised \$930 million in less than three months which ignited the growth in the BDC industry.
  - Shifted the focus to the externally managed model
- There has been a steady stream of BDC IPOs since that period.
  - Six IPOs completed in 2014 alone
- Today, traded BDCs collectively had approximately \$64 billion in total assets
- Since 2008, traded BDCs have raised approximately \$36.3 billion in capital, including IPOs, follow-on equity, and debt offerings.

# BDC Equity Capital Raised

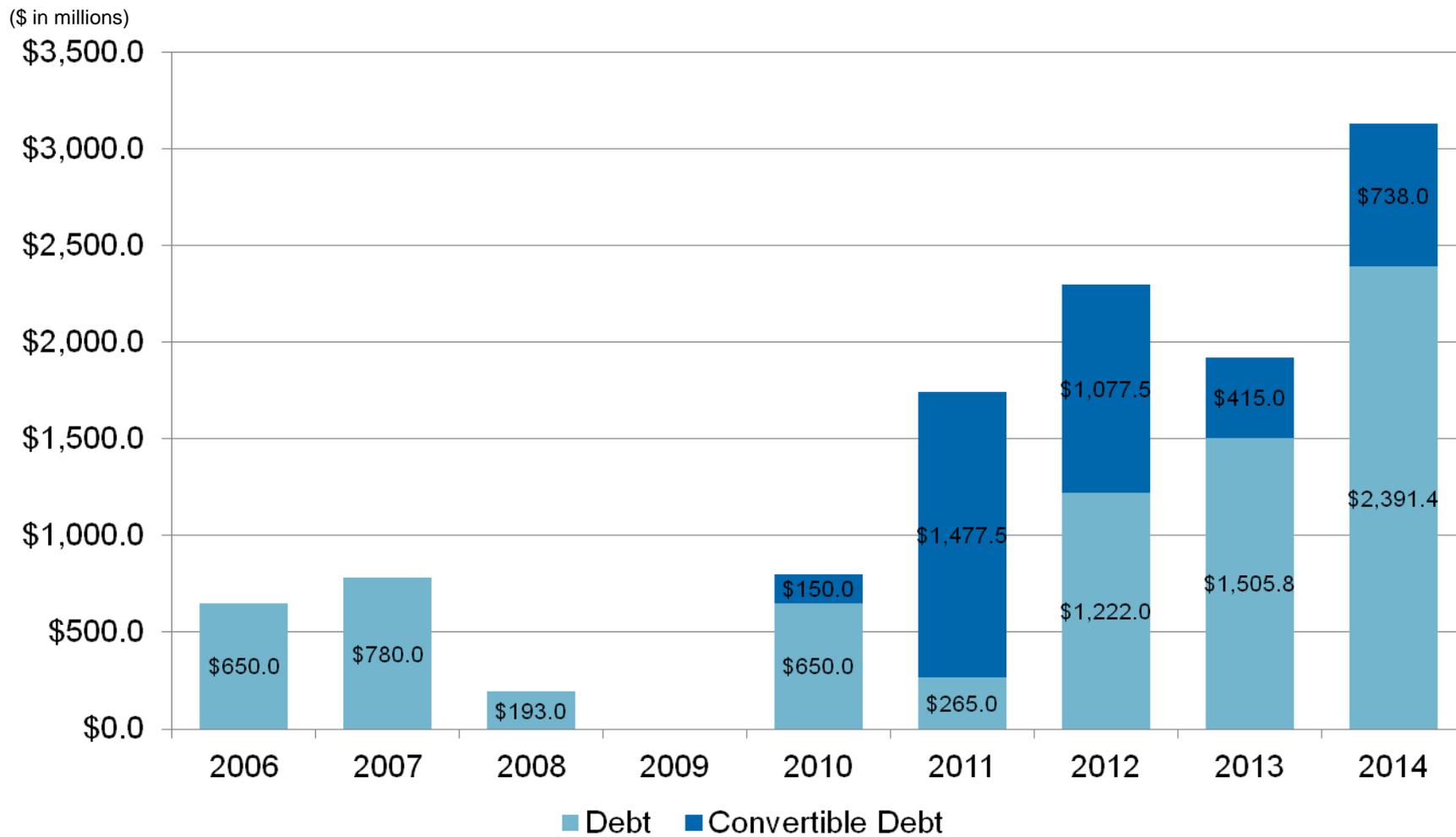
(\$ in millions)



\* Includes traded BDCs, as of December 31, 2014

# BDC Debt Capital Raised

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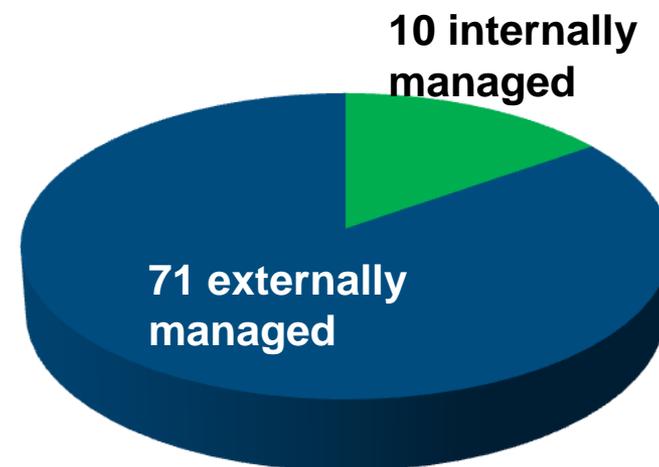


\* Includes traded BDCs, as of December 31, 2014

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# The BDC Industry – at June 2015

- 81 Total Operating BDCs
  - 52 traded BDCs
  - 19 non-traded BDCs
  - 10 private BDCs
- Additional funds in registration
- Traditional closed-end funds are launching non-traded funds
  - Priority Senior Secured Income Fund (joint venture between Behringer Harvard Holdings and Prospect Capital Management)
  - FS Global Opportunities Fund (advisory/sub-advisory relationship between Franklin Square and GSO/Blackstone)



# Part II: Evolving BDC Models

# Types of BDC Models

- **Traded BDCs**
  - Listed on NASDAQ or NYSE
  - Formed either as a blind-pool or through the acquisition of an existing portfolio
  - IPO through traditional firm commitment underwritten offering
- **Non-Traded BDCs**
  - Shares are not listed on an exchange
  - Subject to investor suitability requirements and must be “blue sky” registered in each state where offerings are made
  - Shares sold through continuous offerings up to preset maximum amount
  - Liquidity offering through periodic repurchase offers
  - Typically have 5-7 year period before exchange listing or traditional IPO
- **Private BDCs**
  - Shares are not listed on an exchange
  - Shares are sold through private placement offering and funding effected through a capital call model
  - Intent to conduct an IPO / exchange listing in near term

# Development of Non-Traded BDCs

- REITs have successfully used the non-traded model for years.
- In January 2009, FS Investment Corporation launched the first non-traded BDC.
  - Affiliated with GSO / Blackstone
  - Raised \$2.67 billion through a continuous offering
  - Listed its shares during 2014 to provide shareholder liquidity
- 19 non-traded BDCs are currently selling shares in continuous offerings and have collectively raised more than \$12 billion.
- Enables retail investors that meet certain suitability standards to receive current income and potentially capital appreciation by participating in pre-IPO investing.
- Expectation of liquidity through exchange listing in 5-7 year period
- All the non-traded BDCs that are currently offering and in registration are externally managed.

- Non-traded BDCs are generally structured as a combination of an investment adviser or sub-adviser and a distributor. For example,
  - GSO/Blackstone serves as the sub-adviser for Franklin Square's funds, while FS2 Capital Partners is the dealer manager.
  - KKR Asset Management is the investment sub-adviser for Corporate Capital Trust, while CNL Fund Advisors serves as the dealer manager.
  - Apollo Global Management serves as investment sub-adviser for CION Investment Corp., while ICON Securities serves as the dealer manager.
  - SIC Advisors (investment personnel of Medley) is the investment adviser to Sierra Income Corporation, while SC Distributors is the dealer manager.
  - Business Development Corporation of America is currently the only non-traded BDC that does not utilize a third-party investment adviser or sub-adviser.

# Development of Private BDCs

- In April 2011, TPG Specialty Lending, Inc. launched the first private BDC
  - Listed its shares in 2014 to provide shareholder liquidity
- Typically sponsored by large private equity firms with an existing investor base
- Operates similar to a non-traded BDC, but draws down capital via a capital call model, similar to a private fund structure
- Shares are offered through a private placement offering rather than via a continuous public offering
- BDC/RIC structure helps mitigate need for offshore feeder fund structure for foreign/tax exempt investors
- Private placement structure eliminates need for “blue sky” registration process faced by traditional non-traded BDCs
- IPO / exchange listing expected over time

# Private BDCs Operating

- Private BDCs have been organized to date include:
  - TPG Specialty Lending, Inc. (*completed qualifying IPO in 2014*)
  - Carlyle GMS Finance, Inc.
  - TCW Direct Lending LLC
  - Credit Suisse Park View BDC, Inc.
  - Golub Capital Investment Corp.
  - Audax Credit BDC, Inc.
- In 2013, the SEC adopted amendments Rule 506 under Reg D and Rule 144A under the Securities Act to implement elements of the JOBS Act
- Made the process of forming a private BDC potentially more attractive by eliminating the prohibition on general solicitation if certain undertakings are met

# Part II: BDC Formation and Operational Requirements

# The BDC Formation Process

- Organize the entity as a Delaware or a Maryland corporation
- File an IPO registration statement on Form N-2 under the Securities Act
  - The JOBS Act allows “emerging growth companies” to confidentially file an initial registration statement, minimizing market and reputational risk
- Register a class of securities under the Exchange Act
- Apply to list securities on the NASDAQ/NYSE, or the BDC can be a non-traded BDC
- File Form N-54A to make the election to be regulated as a BDC
- Have N-2 registration statement declared effective by the SEC
- Comply with regulatory requirements of the 1940 Act
- Comply with reporting requirements including the Exchange Act, Sarbanes-Oxley Act, Dodd-Frank Act

# Other Formation Considerations

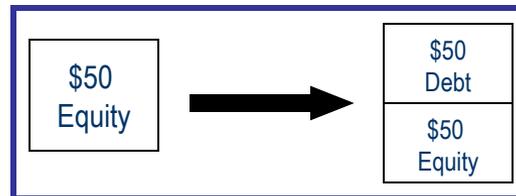
- Typically requires 6 – 8 months to complete IPO
- Consider formation / structuring issues
  - Portfolio acquisition / manage any built-in gain
  - Form of consideration
  - SEC staff expressing more flexibility in acquisition of affiliate assets
- Consider any necessary exemptive relief
  - Co-investment with sister funds
- Prepare registration of investment adviser (if externally-managed)
- Develop compliance / corporate governance programs
- Select service providers
  - Public accountants, custodian, valuation assistance, etc.

# Impact of the JOBS Act on BDCs

- Designed to encourage capital formation for small U.S. businesses
- Permits “emerging growth companies” (EGCs) to confidentially file an initial registration statement
  - EGC is defined as having less than \$1 billion total annual gross revenues in its most recent fiscal year.
- EGCs are exempt from certain requirements of the Sarbanes-Oxley Act
  - EGCs planning an IPO have more time to ramp up their SOX programs, allowing the companies to focus on expanding their business
  - For the five years following an IPO, companies with revenues of less than \$1 billion a year are not required to comply with Section 404(b) of SOX, which requires external auditors to attest to the EGC’s internal controls over financial reporting unless:
    - The company’s revenue grows to more than \$1 billion,
    - The company issues more than \$1 billion in nonconvertible debt over a three-year period, or
    - The company’s worldwide public float exceeds \$700 million.
- EGCs must continue to comply with the other provisions of SOX, including management certification that internal controls are operating effectively.

# 1940 Act Operational Requirements

- BDCs must invest at least 70% of its assets in eligible portfolio companies. Generally:
  - Organized and principally operating in the United States
  - Private, or very thinly traded public companies
- BDCs must have 200% asset coverage (i.e. total assets/ total debt)
  - For example, a BDC with \$50 in equity can borrow up to \$50 in debt, thus would have \$100 to invest in private business



- BDCs are highly regulated in affiliated and joint transactions
  - Certain transactions may be prohibited, or require approval of a majority of the Board, or an order from the SEC

# 1940 Act Operational Requirements

- Must have a majority of independent directors
- Must appoint a Chief Compliance Officer and maintain a comprehensive compliance program
- Must maintain a Code of Ethics, custody agreement and a fidelity bond
- Must maintain specified books and records
- Subject to SEC examination
- Limitations on indemnification
- Must make available significant managerial assistance to portfolio companies

# Primary Compliance Considerations

- Regulated by the SEC's Division of Investment Management
- Rule 38a-1 of the 1940 Act requires BDCs to have a comprehensive compliance program
  - Oversight of compliance with all federal securities laws
  - Quarterly testing and documentation intended to ensure program effectiveness
  - Chief Compliance Officer reports directly to the Board of Directors
  - Management expected to set tone at the top
- Rule 206(4)-7 of the Advisers Act requires the investment adviser to have a comprehensive compliance program
- SEC's Office of Compliance, Inspections and Examinations have exam authority
  - Risk-based exams may occur at any time

# Exchange Listing Standards

- BDCs that have their securities listed or traded on NASDAQ/ NYSE must comply with the corporate governance listing standards, including:
  - A listed BDC must have an audit committee composed solely of independent directors
  - Director nominees of a listed BDC must be selected or recommended for the Board's selection by a nominating committee or the vote of a majority of the BDC's independent directors (depending on the exchange)
  - Independent directors of the BDC must hold regularly scheduled executive sessions
  - The BDC must adopt a code of business conduct and ethics, various committee charters and, in the case of NYSE-listed BDCs, corporate governance guidelines
    - All such documents must be posted on the company's website

# Portfolio Asset Valuation

- Assets are valued quarterly
  - Market value used if market quotes are readily available
  - Fair value used for other securities and assets, as determined in good faith by the board of directors
    - Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date.
  - Each security separately valued and disclosed in quarterly reports
- No single standard for determining fair value in good faith
  - Requires examination and review of the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process
- ASC 820 – public companies’ financial instruments must generally be valued at their current market price (i.e. “mark to market”)

# SEC Reporting Requirements

- 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
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting/Attestation
  - JOBS Act provides that “emerging growth companies” may take advantage of reduced reporting obligations on internal controls during the first five years

# What are BDCs Investing In?

- Entire spectrum of securities issued by private and thinly traded public companies, including:
  - Senior
  - Second lien
  - Mezzanine
  - Unitranche (blended rate security representing both senior and mezzanine debt)
  - Preferred equity
  - Common equity and warrants
- Typical BDC borrower is:
  - Small to middle-market U.S. company
  - Rated below investment grade “BBB-” or equivalent
- Although the majority of BDCs invest primarily in debt securities, several BDCs are equity focused

# Portfolio Considerations

- Composition of the portfolio will affect trading characteristics of the BDC
- Debt securities (senior, mezzanine or unitranche):
  - May generate current income
  - May reflect unrealized depreciation if asset becomes impaired
  - May generate “paid in kind” (PIK) or other non-cash income that must be distributed
- Equity securities – preferred, common, warrants or rights
  - May generate realized capital gains or losses
  - May reflect unrealized appreciation or depreciation
- Industry focus
  - Market sentiment may change over time
    - Energy, Technology, etc.

# Taxation as a RIC

- A BDC may elect to be taxed as a “regulated investment company,” or RIC, under the Internal Revenue Code
  - Allows “pass through” tax treatment for income and capital gains that are distributed to shareholders – no taxation at the BDC
  - Must distribute at least 90% of its investment income to shareholders annually
  - May retain, distribute or “deem distribute” capital gains
- Annually, at least 90% of gross income must be generated from investment company taxable income (generally, interest, dividends and capital gains)
- Quarterly, at least 50% of assets (at fair value) must be:
  - Cash, cash equivalents, or government securities
  - Securities of other RICs
  - Securities that, with respect to any one issuer, both (1) represents an amount 5% or less of the RIC’s total assets and (2) is not more than 10% of the outstanding voting securities of the issuer
- Quarterly, not more than 25% of the RIC’s total assets can be invested in:
  - Securities of any one issuer (excluding RICs or government securities)
  - Securities of two or more issuers controlled by the RIC and engaged in the same trade or business
  - Securities of qualified publicly traded partnerships

# Contact Information

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## Business Development Companies Compensation and Affiliate Issues

James G. Silk  
August 13, 2015

# BDC Compensation

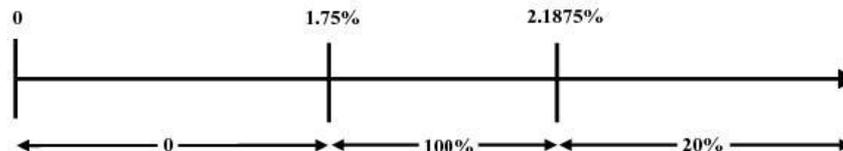
- BDCs have a significant advantage over traditional listed registered closed-end funds in terms of fee structure
- If a BDC has an investment adviser, it may charge performance-based fee in addition to a base management fee
  - Listed closed-end funds cannot charge a performance-based fee
- If a BDC does not have an investment adviser, it can instead have an option plan or profit-sharing plan for its employees and officers
  - 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
    - 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 vehicles to pay compensation based on performance
  - *Registered* investment adviser to a BDC can receive a performance fee
  - 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
  - Generally a fee, not an allocation
- Fees reflected in advisory agreement subject to Investment Company Act approval

## 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 and 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*.
  - Does not include unrealized gains
- If the amount is positive at the end of the year, then the capital gains fee for the year is equal to the stated percentage of the amount, less the aggregate amount of the capital gains fees paid in all prior years.
- The capital gains performance fee cannot exceed 20% (Section 205(b)(3) of the Advisers Act)

## 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 warrants, options, and rights pursuant to an executive compensation plan:
  - If to any officer or employee of a BDC, (1) the 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 of the BDC's common stock at issuance, or if no market value exists, the current net asset value of the common stock; 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;
  - If to any director of a BDC who is not also an officer or employee of the BDC, the proposal, in addition to satisfying (1) and (2) above, must be approved by 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 the BDC or its shareholders;
  - The securities are not transferable except 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, the profit-sharing plan is approved by the *required majority* of the directors of the BDC on the basis that the plan (1) is reasonable and fair to the BDC's shareholders, (2) does not involve overreaching of the BDC or its shareholders on the part of any person concerned, and (3) is consistent with the interests of the shareholders of the BDC; or
  - In the case of a plan that includes one or more directors who are not also officers or employees of the BDC, the plan is approved by order of the SEC on the same three-prong basis set out above; and
  - In each case, 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 (ie, is externally managed)

# 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 are treated differently depending on whether the affiliate in question is a “control” affiliate or “remote” affiliate

# 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 (cont.)

- “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 (cont.)

- 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:
    - a usual and customary broker's commission if the sale is effected on a securities exchange;
    - 2% of the sales price if the sale is effected in connection with a secondary distribution of such securities; or
    - 1% 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
  - Access by Retail and ERISA investors
- 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
  - Volcker considerations
- Perpetual life
  - Permanent equity capital affords longer investment horizon than traditional private funds
  - But can be structured as a limited-lived vehicle
- Attractive fee structure as compared to registered closed-end fund

# Challenges for New BDCs

- Immediate dilution to shareholders as a result of underwriters' commission
  - Advisers subsidizing costs
- Marketing issues
  - Excess supply
  - Limited eligible investments
  - High fees
  - Ramp-up and blind pool aspect
- Tax Considerations by non-US Persons
- Discount to NAV

## Contact Information



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# Business Development Companies:

## Investment Restrictions, Disclosure Issues and Recent Regulatory Developments

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August 13, 2015

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# Investment Restrictions

## ▶ Eligible Portfolio Company Test

- 70% of BDC Investments must be made in “Eligible Portfolio Companies” – agnostic as to type of security (debt or equity)
  - ▶ Must be a US company (organized and principal place of business)
  - ▶ Must be a company that either has (i) no outstanding registered securities or (ii) an equity market capitalization of less than \$250 million
  - ▶ Cannot be an investment company relying on a “3c” exemption under the 1940 Act (includes any private investment company or REIT)
- BDCs must make available significant managerial assistance for these companies
- SEC staff has imposed some restrictions on investments through comments on disclosure regarding investments in complex financial instruments such as total return swaps and unfunded commitments

# Investment Restrictions (con't)

## ▶ Asset Coverage Test

- Assets coverage of at least 200% of indebtedness, equivalent to a 50% debt-to-total capitalization ratio
- Includes all “senior securities.” This includes preferred stock
- Extensive accounting and SEC staff guidance regarding consolidation of debt of subsidiaries of BDCs
  - ▶ Joint Ventures
  - ▶ CLO Equity
  - ▶ Other investment companies and REITs
  - ▶ Specialty finance companies

# Investment Restrictions (con't)

- ▶ Transactions with Affiliates under Section 57:
  - Principal transactions between BDC and entities controlled by affiliate of BDC's adviser are generally prohibited – significant implications for formation transactions
  - Co-investment transactions among BDC and entities controlled by affiliates of a BDC's adviser are limited
    - ▶ Some forms of co-investment are effectively prohibited under current SEC regulations and interpretive guidance
    - ▶ “Mass Mutual” No-Action Letters spell out limited circumstances under which a BDC may co-invest with another fund advised by a BDC's adviser or an affiliate of such adviser
    - ▶ SEC Staff has worked with the Commission to issue exemptive relief orders which extend the co-investment framework of the Mass Mutual No-Action letters to “originated” transactions
  - Agency transactions: Limited fees may be earned by an affiliate of a BDC's adviser for providing a BDC with some agency services

# Disclosure Issues

- ▶ Offering Fees and Expenses; expense reimbursement
- ▶ Valuation methodology and board processes
- ▶ New Test: coverage of unfunded commitments (1) with offsetting liquid assets or (2) if such commitments were to be treated as liabilities, ability to meet 200% Asset Coverage Test under the 1940 Act-evolving standard
- ▶ Treatment of non-cash income (e.g., payment-in-kind and discounted securities)
- ▶ “Seniority” of Debt issued by BDCs
- ▶ Undertakings in connection with shelf registration (final opinions; below-NAV offerings; confirmation of NAV within 48 hours of equity offering)

# Regulatory Developments

- ▶ SEC staff focus on BDCs increasing
- ▶ Valuation and recent enforcement transactions
- ▶ Unlisted BDCs: FINRA issues; proposed DOL Fiduciary Standard for Certain Investment Accounts

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