Market Trends 2017/18: Business Development Companies

A Lexis Practice Advisor® Practice Note by
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OVERVIEW

Business development companies (BDCs) are closed-end investment management companies that are specially regulated by the Investment Company Act of 1940, as amended (the 1940 Act). BDCs provide capital to, and invest in, small and middle-market companies in the United States. As a result of their special investment purpose, BDCs are exempt from certain regulatory constraints imposed by the 1940 Act on traditional investment companies and generally benefit from pass-through tax treatment (i.e., where the entity is not taxed in favor of the tax burden passing on to the owners of the entity).

To be regulated as a BDC, a company must elect to be subject to the provisions of Sections 55 through 65 of the 1940 Act. Given the limited access to, and availability of, financing from traditional bank lenders, BDCs have recently played an important and increasing role as a crucial source of capital and liquidity to small and mid-sized companies that may not be able to otherwise obtain financing or do so at attractive rates.

In addition to the 1940 Act, BDCs and their securities are typically also registered under the Securities Act of 1933, as amended (the Securities Act), and the Securities Exchange Act of 1934, as amended (the Exchange Act), and are subject to the registration and reporting requirements under those two regulations. For additional information on BDCs, see Business Development Companies.

BDCs generally continued their trend of trading lower during the second half of 2017. With credit spreads continuing to tighten and increasing interest rates, market expectations would be for a challenging and competitive lending environment to remain in-place for BDCs in 2018.

NOTABLE TRANSACTIONS

In June 2017, Carlyle Global Credit, an affiliate of The Carlyle Group (Carlyle), sponsored an initial public offering (IPO) of its externally-managed BDC, TCG BDC Inc., on the Nasdaq Global Select Market under the symbol CGBD. The IPO priced at the bottom of its $18.50 and $19.50 per share range. BofA Merrill Lynch, Morgan Stanley, J.P. Morgan, and Citigroup acted as joint book-running managers for the offering. Keefe, Bruyette & Woods, A Stifel Company, and Wells Fargo Securities acted as bookrunners for the offering, and HSBC and Mizuho Securities acted as co-managers for the offering.

CGBD launched its IPO with a $1.4 billion portfolio primarily consisting of first lien senior secured loans and second lien senior secured loans. Since it commenced investment operations in May 2013, the BDC invested more than $2.4 billion in aggregate principal amount of debt and equity investments prior to any subsequent exits or repayments.

In connection with the offering, CGBD's investment advisor agreed to pay 50% of the total sales load (i.e., underwriting discount) and 50% of the offering expenses incurred in connection with the offering. CGBD was not obligated to repay its investment advisor for those expenses in the future. Additionally, upon consummation of the offering, individuals affiliated with Carlyle adopted a 10b5-1 plan allowing the participants to buy up to $15 million of CGBD's common stock in the open market a month following the offering. For further information on 10b5-1 plans, see Rule 10b5-1 Plans and Advising on Their Use and 10b5-1 Plans Best Practices Checklist.

DEAL STRUCTURE AND PROCESS

Shelf Offerings

The use of the shelf registration statement process has proven particularly useful for publicly-listed BDCs that trade at a premium to net asset value (NAV) for only a short, and typically unpredictable, period of time. An effective shelf registration statement enables a BDC to access capital markets when needed or when market conditions are optimal. The shelf registration statement can be filed with the Securities and Exchange Commission (SEC) and reviewed while the BDC is trading at a discount to its NAV and then can be used to conduct an offering of the BDC's shares when market conditions permit or following approval from its stockholders for below-NAV issuances. The typical SEC review process for an initial shelf registration statement takes approximately 30 to 45 days from the initial filing. Takedowns from an effective shelf registration can then be consummated without SEC staff review or delay. For further information on shelf registration, see Shelf Registration, Market Trends 2016/17: Shelf Registrations and Takedowns, Top 10 Practice Tips: Shelf Registration Statements and Takedowns, and Shelf Offerings. For information on the SEC review process, see Understanding the SEC Review Process and Top 10 Practice Tips: Responding to SEC Comment Letters.

The SEC generally limits the cumulative dilution to a BDC's current NAV per share that a BDC may incur while using a shelf registration statement to sell shares of common stock at a price below NAV. A BDC can complete multiple offerings off of an effective shelf registration statement only to the extent that the cumulative dilution to the BDC's NAV per share does not exceed 15%. Once the cumulative dilution exceeds 15%, the BDC must file a post-effective amendment to the shelf registration statement or file a new shelf registration statement.

BDCs typically use shelf registration statements to issue debt and equity securities. Debt securities are issued by BDCs from time to time either in follow-on offerings (i.e., offerings after the IPO) or takedowns from a medium-term note program. For additional information on follow-on offerings and medium-term note programs, see Follow-On Offerings Resource Kit, Top 10 Practice Tips: Follow-on Offerings, and Medium-Term Note (MTN) Programs. BDCs also frequently list their debt securities on a national securities exchange (such debt securities are referred to as baby bonds due to their low minimum denominations). Equity securities are issued by BDCs from time to time either in follow-on offerings or in at the-market (ATM) offerings as described in more detail below.

In addition to the types of securities offerings mentioned above, a BDC may also issue and sell rights under its shelf registration statement that convert into voting securities even when its common stock is trading below NAV, subject to certain limitations. In a rights offering, the BDC's existing stockholders receive the opportunity to purchase, on a pro rata basis, newly issued shares of the BDC's common stock at an exercise price typically set at a significant discount to the market price of the common stock. A rights offering may be a useful way of raising capital while avoiding stockholder approval requirements. Rights offerings may be either transferable or non-transferable. A transferable rights offering permits the subsequent sale of such rights in the open market. The SEC has generally taken the position that no more than one additional share of common stock may be issued for each three shares of common stock currently outstanding in connection with a transferable rights offering below NAV. Due to the reduced dilution concern, non-transferable rights offerings are not subject to the same limitation. For further information on rights offerings, see Rights Offerings and Rights Offering Checklist.

ATM Offerings

An ATM offering is an offering of securities into a publicly-listed BDC's existing trading market for outstanding shares of the same class at other than a fixed price (i) on, or through the facilities of, a national securities exchange or (ii) to or through a market-maker. Therefore, the price at which securities are sold in an ATM offering will vary because it is based on the price of the securities in the BDC's trading market. An equity distribution program provides a means for a BDC to conduct ATM offerings from time to time using a shelf registration statement to or through a broker-dealer acting either on a principal or agency basis. Each ATM offering then is a takedown from the related shelf registration statement. For further information, see At-the-Market Offerings and Equity Distribution Agreements for At-the-Market Offerings.

The BDC can either (i) use an allocated portion of an already existing universal shelf registration statement specifically for ATM offerings or (ii) prepare a new shelf registration statement specifically for ATM offerings. If the issuer decides to use an already existing shelf registration statement, then the BDC must prepare a prospectus supplement specifically for the equity distribution program. At the time the ATM offering commences, the BDC will file a prospectus supplement pursuant to Rule 497 (17 C.F.R. § 230.497) under the Securities Act that discloses the terms of the offering, including the name of the sales agent. A post-effective amendment to the shelf registration statement will be filed with the equity distribution agreement entered into between the BDC and the sales agent. Note that for BDCs, the equity distribution agreement is subject to the requirements of Section 15(c) (15 U.S.C.S. § 80a-15) of the 1940 Act and must be approved at an in-person board meeting called for the purpose of voting on the agreement by a majority of the BDC's directors who are not interested parties.

Private BDCs

Recently the number of IPOs consummated by BDCs has been limited and the private BDC has emerged as a popular alterative for sponsors seeking to access the BDC structure. A private BDC is one that offers and sells its securities in a private placement to accredited third-party investors without registering its securities under the Securities Act. For additional information on private placements, see Private Placements Resource Kit and Top 10 Practice Tips: Private Placements. More than ten private BDCs have been brought to market since 2016.

Private BDCs are usually sponsored or formed by parent private equity firms or financial institutions that already have the necessary pre-existing relationships with the needed accredited third-party investors. Notwithstanding the lack of a public securities offering, the private BDC must still comply with the Exchange Act reporting requirements similar to its public company BDC peers because it is required to register by the 1940 Act.

This private BDC structure provides sponsors an alternative that combines elements of a private fund with elements of a traditional BDC. For instance, the private BDC must still comply with the 1940 Act governance and investment limitations and restrictions applicable to traditional BDCs. However, the private BDC has the flexibility to build committed capital calls into its structure similar to other private funds in order to allocate capital when investment opportunities arise and provide investors with a defined liquidity event.

Another advantage to the private BDC structure is that, instead of using a Form N-2 for an IPO, private BDCs may file a Form 10 under the Exchange Act which is typically subject to a shorter review period by the SEC. For additional information on Form 10, see Form 10 Drafting.

LEGAL AND REGULATORY TRENDS

Small Business Credit Availability Act

Over the past several years, various congressional bills have been introduced and considered in both houses of Congress in an attempt to relax the asset coverage requirement applicable to BDCs. Under the 1940 Act, any debt or senior security issued by a BDC must have asset coverage of at least 200%, which is less restrictive than the 300% asset coverage requirement imposed on traditional closed-end funds and mutual funds. Additionally, no dividends can be declared on a BDC's common stock unless its debt and senior securities have asset coverage of at least 200%. As a result, BDCs have historically been required by the 1940 Act to maintain a maximum 1:1 debt-to-equity leverage ratio.

On March 23, 2018, President Trump signed into law the Consolidated Appropriations Act of 2018 (also known as the omnibus spending package), which included the adoption of the Small Business Credit Availability Act. The Small Business Credit Availability Act reduces the asset coverage requirement applicable to BDCs from 200% to 150%. This reduction has the potential to allow electing BDCs to maintain a maximum 2:1 debt-to-equity leverage ratio.

Increasing the leverage limit may allow BDCs, which are a significant source of capital for small and medium-sized businesses, to deploy additional (possibly lower-risk senior) capital to borrowers and potentially increase their total returns without needing to deploy higher risk junior capital in order to obtain higher yields.

In order to elect to reduce the asset coverage requirement, the Small Business Credit Availability Act requires that either one of the following be true:

- A majority of the BDC's board of directors and a majority of its disinterested directors (as defined under the 1940 Act) approve the decreased asset coverage ratio, which effectiveness would be delayed one year following the approval.
- A majority of the BDC's stockholders approve the decreased asset coverage ratio, which would be immediately effective following the approval.

In either scenario, a BDC that opts to rely on the reduced asset coverage requirement must publicly disclose within five business days its election to do so and provide the market with the BDC's existing leverage ratio and risks associated with increasing the leverage ratio. Further, a BDC that is not traded on a national securities exchange is required to offer its stockholders an opportunity to have their shares repurchased by the BDC following the approval to increase the leverage ratio.

The Small Business Credit Availability Act also requires the SEC to implement amendments to various Securities Act rules and regulations to provide parity for BDCs in relation to their corporate peers with respect to securities offerings, offering-related communications, and research safe harbors.

In particular, the SEC is required to adopt rules to implement the following:

- BDCs will be able to qualify as well-known seasoned issuer (WKSIs). As currently permitted, WKSIs are able to file automatically effective registration statements avoiding delays in connection with an SEC review. WKSIs are also able to use free writing prospectuses before the filing of a registration statement and may engage in certain pre-filing communications. For further information, see WKSIs and Seasoned Issuers.
- BDCs will be permitted to rely on incorporation by reference in their public filings and the ability to file a form of prospectus and final prospectus under Rule 424 of the Securities Act. For further information, see Rule 424 Prospectus Supplements Filing.
- BDCs will be permitted to rely on communication-related safe harbors already available to other corporate issuers. These communication safe harbors include the ability to (i) make offering communications prior to

the declaration of an effective registration statement, (ii) issue regularly published research reports by broker-dealers, and (iii) release factual business information. For further information, see When is a Communication an Offer of Securities? Chart and Registered Offerings: Applicable Laws, Rules, and Regulations — Permitted Communications in Registered Offerings.

These changes, once implemented, will provide much needed cost savings to BDCs and efficiency to securities offerings by BDCs without the risk of negatively impacting investors.

Industry Reaction to Reduced Asset Coverage Ratio for BDCs

Following the enactment of the Small Business Credit Availability Act, many BDCs immediately sought approval to reduce their asset coverage requirement. BDCs that have publicly announced approval from the required majority of their board of directors to decrease the asset coverage ratio (following a one-year wait period), included the following: Apollo Investment, New Mountain Finance, Monroe Capital, Stellus Capital, PennantPark Floating Rate Capital, and Gladstone Capital. As a result of new industry guidelines set forth by Standard & Poor's (as discussed below), Prospect Capital and FS Investment each reversed its board of director's prior approval to lower the asset coverage ratio.

Additionally, the boards of directors of New Mountain Finance, Monroe Capital, and Stellus Capital recommended that their stockholders approve the asset coverage ratio reduction at this year's annual stockholder's meeting. Approval by the stockholders would allow the asset coverage ratio change to take immediate effect for the BDC and avoid the one-year waiting period required in connection with the already obtained board approval.

Certain BDCs, such as THL Credit, are contractually limited in their ability to reduce their asset coverage ratio because negative financial covenants included in their credit facilities require maintenance of the 200% asset coverage threshold notwithstanding the change in law.

Several credit rating agencies, including Standard & Poor's, Fitch Ratings, and Kroll Bond Rating Agency, view the adoption of a lower asset coverage ratio by BDCs as a negative development and believe that it generally increases credit risk in the industry. Standard & Poor's provided public guidance that it would likely downgrade any BDC that obtains or seeks approval to reduce its asset coverage ratio.

Other Legal and Regulatory Trends

Last year, the Staff of the Division of Corporation Finance of the SEC announced that it would expand its acceptance of draft registration statement submissions from emerging growth company to all companies seeking a review of their registration statement. This expansion of the confidential registration statement review process was made available for both IPOs and those offerings within one year of a public company's IPO. Notwithstanding the expanded availability, the process of the non-public, confidential review was left unchanged requiring issuers to publicly file the confidentially submitted registration statement (and other nonpublic draft submissions) at least 15 days prior to any marketed offering presentation or at least 15 days prior to the requested effective date of the registration statement.

As a result of the aforementioned expanded confidential review process, on March 16, 2018, the Staff of the Division of Investment Management of the SEC announced that it will similarly accept draft registration statements that are submitted by a BDC (even if the BDC does not qualify as an emerging growth company) for non-public, confidential review. The Division also will similarly accept for nonpublic, confidential review draft registration statements relating to offerings that are submitted by BDCs within one year of an IPO.

MARKET OUTLOOK

In addition to the reforms adopted as part of the recently enacted Small Business Credit Availability Act, many BDC industry participants have recommended that the Staff of the Division of Investment Management of the SEC remove or alter the line item titled "Acquired Fund Fees and Expenses" (AFFE) that is currently required to be included in a BDC's prospectus fee table. The calculation of AFFE typically results in an overstated expense ratio because an acquiring fund's indirect expenses are often significantly greater than the expense ratio of the BDC. The BDC market would likely be receptive if the SEC Staff takes action with respect to AFFE disclosure in 2018.

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Brian Hirshberg is counsel in Mayer Brown's New York office and a member of the Capital Markets practice. He focuses on representing issuer, sponsor and investment bank clients in registered and unregistered securities offerings. He has led a variety of transactions, including public equity and debt offerings; Rule 144A offerings; tender and exchange offerings; preferred stock offerings; and debt offerings for companies in various industries, including specialty finance, real estate and real estate investment trusts, business development, life science, healthcare and aviation. Additionally, he assists public company clients with ongoing securities law compliance requirements, including stock exchange obligations, shareholder-related disputes and corporate governance matters.