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Professional Perspective

New Securities Regulations May Benefit BDCs

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Several key regulatory developments and reforms have the potential to significantly help business development companies (closed-end investment management companies that are specially regulated by the Investment Company Act of 1940). This article addresses those developments and how they are expected to impact the BDC industry.

BDCs provide capital to, and invest in, small and middle-market companies in the U.S. As a result of this 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.

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.

Proposed Securities Offering Reforms

Communication Reforms Now Effective

The securities offering and offering-related communication reforms that were included in the Small Business Credit Availability Act became automatically effective on March 23, 2019 because the Securities and Exchange Commission did not issue final rules prior to the one-year anniversary of the Act. While the communications safe harbors and securities offering related accommodations for well-known seasoned issuers have been available to corporate issuers for more than a decade, BDCs are now allowed to similarly rely on the following provisions:

- BDCs may now qualify as a well-known seasoned issuer or WKSI (this permits, among other things, the use of automatically effective shelf registration statements and free writing prospectuses).
- BDCs may now incorporate by reference (backwards and forwards) in their registration statements from other filings.
- BDCs may now rely on access equal delivery rules (this removes the requirement to "print and deliver" prospectuses).
- BDCs may now rely on expanded communication safe harbors (this permits the release of factual and forward-looking business information).

These changes should provide cost savings to BDCs and lead to greater efficiencies in connection with securities offerings undertaken by BDCs.

Modernizing Provisions and Safe Harbors

The SEC proposed rule amendments on March 20, 2019 to address the mandate in the Act that the SEC modernize the offering-related provisions and the communications safe harbors available to BDCs under the Securities Act of 1933. The SEC also proposed accompanying amendments to Form N-2, which is the form BDCs must use to offer securities. Certain of the proposed rule amendments revise provisions that became automatically effective on the Act's one-year anniversary as described immediately above.

Although these provisions became automatically effective without rule amendments it is difficult to rely on certain securities offering related provisions because the SEC has not formally provided approved guidance. These proposed amendments are welcome given that historically the offering process for these entities has been cumbersome and has affected access to capital formation.

Proposed Registration Exemption Changes

While the majority of BDCs have a class of equity securities that is listed on a national securities exchange, many have elected to remain private. A private BDC offers and sells its securities in a private placement to accredited third-party investors without registering the offer of its securities under the Securities Act.

Expand Accredited Investor Definition

The SEC voted on Dec. 18, 2019 to approve a proposing release for public comment that would amend the definition of "accredited investor," as well as amend the definition of "qualified institutional buyer." These amended definitions would broaden the potential universe of individuals and entities that might qualify as accredited investors. In particular, the proposed amendments to the accredited investor definition would add new categories of natural persons based on professional knowledge, experience or certifications and would leave intact the current net income and asset tests.

The proposed amendments would also add new categories of entities, including a "catch-all" category for any entity owning in excess of $5 million in investments and would similarly expand the definition of a "qualified institutional buyer" to include additional entities, which would allow private BDCs to access a greater number of investors in exempt offerings.

Harmonize Exempt Offerings

The SEC issued a concept release on June 18, 2019 on ways to "simplify, harmonize, and improve the exempt offering framework to expand investment opportunities while maintaining appropriate investor protections and to promote capital formation." The concept release sought public comment on a wide range of issues, including potential changes to the existing exempt offering framework and the accredited investor definition (consistent with the SEC's proposed amendments described immediately above). Securities of private BDCs are typically offered pursuant to private placement exemptions with accredited investors making up a very substantial proportion of private BDC investors. Certain registration exemptions (such as Regulation A) are not available to BDCs under current law. The SEC's request solicited comments as to whether the eligibility to rely on certain registration exemptions should be extended to BDCs and whether there are regulations that discourage, or have the effect of discouraging, participation by BDCs in exempt offerings.

Adopted Reforms

Testing-the-Water Communications

On Sept. 26, 2019, the SEC adopted new Rule 163B and related amendments under the Securities Act to expand the permitted use of "testing-the-waters" communications to all companies regardless of size or reporting status, including BDCs. The new rule enables any BDC, including one that is not an emerging growth company or any person authorized to act on the BDC's behalf, to make oral and written offers to qualified institutional buyers and institutional accredited investors before or after the filing of a registration statement to gauge investors' interest in an offering of securities by the BDC.

No Quiet Period

The SEC approved the Financial Industry Regulatory Authority, Inc. amendments to FINRA Rule 2210 (Communications with the Public) and FINRA Rule 2241 (Research Analysts and Research Reports) on Aug. 16, 2019. FINRA's amendments eliminate the "quiet period" restrictions on publishing a research report or making a public appearance concerning a BDC and create a filing exclusion for BDC research reports. Under the FINRA exception, the quiet period requirements do not apply to a research report or a public appearance following any offering of BDC securities that are the subject of a research report. The FINRA amendments align with the SEC's amended rules and are expected to reduce obstacles that previously prevented investors from accessing research reports relating to BDCs.

Remote Voting

The staff of the Division of Investment Management issued a no-action letter on Feb. 28, 2019 to the Independent Directors Council permitting board members of a BDC to vote by telephone, video conference or other remote means in certain circumstances. This modernized position softens, but does not eliminate, the unnecessary burden for BDCs and their boards to adhere to certain in-person voting requirements. For example, the 1940 Act and rules promulgated thereunder provide that the approval or renewal of an advisory contract requires the vote of directors at an in-person board meeting.

The no-action relief may be relied upon if a director is unable to meet at an in-person board meeting as a result of unforeseen or emergency circumstances. Such circumstances could include illness or death, including of family members, weather events or natural disasters, acts of terrorism and disruptions in travel that prevent some or all directors from attending an in-person board meeting. Additionally, either no material changes may be proposed at the board meeting to the existing contract, plan or arrangement or the material aspects of the proposed new contract, plan or arrangement must have been previously discussed at a prior in-person board meeting (without a vote). If relying upon the no-action relief, the directors are required to ratify the prior approval at the next in-person board meeting.

Additional Proposed Reforms

Expedited Review

The SEC proposed rule amendments on Oct. 18, 2019 that would establish an expedited review process for exemptive applications under the 1940 Act that are substantially similar to other recently approved applications and introduce a new informal process for applications that do not qualify for the new expedited process.

The proposed amendments are intended to make the application process more efficient and transparent. Expedited review would be available if an application is substantially similar to two other applications for which an order granting relief has been issued within two years of the date of the application's initial filing.

Use of Derivatives

The SEC proposed on Nov. 25, 2019 a new rule to clarify the use of derivatives by registered investment companies, including BDCs. The proposed rule would provide a more comprehensive approach to the regulation of a BDC's use of derivatives.

Proposed Rule 18f-4, an exemptive rule under the 1940 Act, would permit BDCs to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under Section 18 of the 1940 Act and impose a uniform set of conditions for such transactions. Conditions would include implementation of a derivatives risk management program and a limit on the BDC's use of leverage. The proposed rule is currently subject to public comment.

Financial Statement Reform

The SEC proposed on May 3, 2019 amending the financial statement requirements for acquisitions and dispositions of businesses and related pro forma financials. These changes are intended to reduce complexity and costs of preparing the required financial statements. When a BDC acquires a significant business, Rule 3-05 of Regulation S-X generally requires it to provide separate audited annual and unaudited interim pre-acquisition financial statements of that business. The number of years of financial information that must be provided depends on the relative significance from an accounting perspective of the acquisition to the BDC. The proposed changes would, among other things, add a new Rule 6-11 and amend Form N-14 to cover financial reporting for fund acquisitions by BDCs.

Other Regulatory Developments

The Office of Compliance Inspections and Examinations issued a Risk Alert to provide market participants with information on the most frequently cited deficiencies and weaknesses that the OCIE has observed in recent examinations of investment advisers. The OCIE found that in some cases a fund's board did not request or consider information from the investment adviser (such as the adviser's profitability, economies of scale or peer group fee comparisons) that would have allowed the board to evaluate the approval or renewal of an investment advisory agreement. The OCIE also cited deficiencies in compliance policies that were not consistently followed or enforced, including with respect to board-approved valuation policies.

The staff of the Division of Investment Management released frequently asked questions intended to assist BDCs that have obtained the requisite approvals for lowering their asset coverage from 200% to 150% in satisfying the applicable repurchase offer obligation. As required by Section 61(a) of the 1940 Act, any BDC the securities of which are not listed on a national securities exchange must extend to each shareholder the opportunity to sell such shareholder's securities to the BDC.

The staff confirmed that the requirement is triggered as of the date of the approval (even if a class of the BDC's equity securities is subsequently listed on an exchange) and that the BDC may extend either a single offer to repurchase all the securities held by all BDC shareholders, with the repurchase of 25% of the securities of such shareholders who accept the offer to be effectuated quarterly or four separate, quarterly offers to repurchase 25% of the securities held by all BDC shareholders, with the repurchase of the securities of such shareholders who accept each offer to be effectuated in the same quarter as the offer. The price at which each repurchase is effectuated should be based on the current net asset value of the non-traded BDC at the time of that repurchase, rather than the net asset value at the time of the offer.

BDC Proposals for 2020

While the rule amendments proposed by the SEC in March 2019 would be very helpful to BDCs (if adopted), additional regulatory reforms could be incorporated into the final amendments that would provide further benefit. In particular, BDC industry participants have suggested that the SEC consider adopting the following revisions:

- Because the current WKSI definition is not tailored for a BDC, a BDC that has a net asset value in excess of $700 million but has a public float less than $700 million would not qualify as a WKSI under the proposed rules. An alternative test should be incorporated into the final rule that would allow a BDC to qualify as a WKSI if it has either a public float or a net asset value of at least $700 million. Such an alternative test would increase the number of qualifying BDCs, which would benefit from being WKSIs.

- Instead of the proposed requirement to have BDCs report material write-downs in fair value of significant assets in a Form 8-K filing, require BDCs to include specific disclosure regarding material write-downs in fair value of significant assets in quarterly and annual reports. BDCs typically value their portfolios and calculate net asset value on a quarterly basis. A material change in the value of a single security is not necessarily analogous to a material impairment to an asset (the current trigger for a Form 8-K filing). Providing investors with information relating to the volatility inherent in a single investment during a quarter is unlikely to be as useful as providing investors with the entire portfolio's net asset value at the end of the period accompanying required disclosure relating to the single security's write-down in fair value.

In addition to the proposed reforms, many BDC industry participants have recommended that the SEC's Division of Investment Management remove or alter the line item titled “Acquired Fund Fees and Expenses” that is currently required to be included in a BDC's prospectus fee table. AFFE disclosure requires acquiring funds to aggregate and disclose in their prospectuses the amount of total annual acquired fund operating expenses and express the total amount as a percentage of an acquiring fund's net assets.

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. As a consequence, some index providers removed BDCs from their indices, causing a significant reduction in institutional ownership of BDCs.

The Coalition for Business Development, Apollo Investment Management, L.P., and Ares Capital Management LLC requested on Sept. 4, 2018 that the SEC issue an exemptive order exempting BDCs from the AFFE disclosure. On Dec. 19, 2018, the SEC formally requested industry suggestions to improve AFFE disclosure. Additionally, the House Appropriations Committee 2019 fiscal year appropriations bill contained language recommending that the SEC address the AFFE rule as it applies to BDCs. The BDC sector would benefit from action with respect to AFFE disclosure in 2020.

Incorporating the revisions suggested above and addressing the AFFE rule would significantly benefit BDCs and indirectly benefit U.S. small and middle-market companies that are the primary beneficiaries of BDC capital.