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MODERNIZING THE REGULATORY FRAMEWORK FOR BDCs

Recent legislation amends the regulatory framework applicable to BDCs, and is designed to remove past obstacles and put their securities offerings on a par with those of operating companies. The author discusses the past regulatory framework creating impediments for BDCs, and then turns to the new legislation and the mandated changes to SEC rules.

By Anna T. Pinedo *

Even though nearly 10 years have elapsed since the onset of the financial crisis, lending by banks to small- and medium-sized enterprises has not returned to pre-financial crisis levels. Dodd-Frank Act mandated-regulations, changes brought about by the implementation of Basel III rules, and restrictions on leveraged lending together have had the effect of limiting the willingness of banks to lend to smaller businesses. This has created a lending void, and this void has been filled in large measure by non-bank or alternative lenders.[1] Business development companies, or BDCs, have become increasingly more important as direct lenders that provide needed funding to smaller companies. Recognition of the important role played by BDCs may have served as an important catalyst for the adoption of recent legislation that amends the regulatory framework applicable to BDCs. This article provides an overview of these changes.

AN OVERVIEW OF BUSINESS DEVELOPMENT COMPANIES

BDCs often are referred to as hybrid vehicles. Although BDCs are closed-end investment companies, they are exempt from many of the requirements typically imposed by the Investment Company Act of 1940 on funds. BDCs originally were envisioned as public vehicles that would provide venture capital type funding to portfolio companies. Early BDCs tended to invest in the equity securities of private companies, following a venture capital fund investment approach. By contrast, it is more often the case that recently formed BDCs invest in senior or subordinated debt securities of private companies. Under the Investment Company Act, a BDC is defined as a domestic closed-end company that: (1) operates for the purpose of making investments in certain securities specified in Section 55(a) of the Investment Company Act and, with limited exceptions, makes available significant managerial assistance with respect to the issuers of such securities and (2) has elected business development company status. Generally, a substantial percentage of a BDC's total assets must be comprised of investments in privately issued securities purchased from eligible portfolio companies. An eligible portfolio company is a domestic

[1] Andrea Beltratti and Jonathan Bock, "BDCs: The Most Important Commercial Lenders You've Never Heard About," Journal of Alternative Investments, 2018, 20 (4), pp. 8-20.

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issuer that either does not have a class of equity securities that is listed or quoted on a national securities exchange, or has a class of equity securities listed or quoted on a national securities exchange but has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million and is not, in either case, a registered or unregistered investment company.[2] BDCs, like other investment companies, are subject to restrictions on transactions with affiliates, are subject to restrictions on the types of securities that they may issue, must meet certain diversification requirements, must distribute a minimum of 90% of their taxable earnings on a quarterly basis, and are subject to heightened governance and compliance requirements.

Despite the Investment Company Act regulatory framework applicable to BDCs, which imposes some constraints on their operations, BDCs have become popular in recent years. In addition to electing to be treated as a BDC under the Investment Company Act, a BDC usually will register and offer its common stock under the Securities Act of 1933, by preparing and filing with the Securities and Exchange Commission a registration statement under Form N-2. A BDC that undertakes a public offering of its securities may choose to list its common stock on a national securities exchange. As a BDC will be able to offer its securities publicly, it will be able to access funding regularly and invest the capital it raises in additional eligible portfolio company investments. Private equity fund sponsors and other investment professionals, accustomed to interests in funds that may only be offered to institutional and high net worth investors and that are subject to shareholder redemptions, appreciate that a BDC provides a permanent capital vehicle. Private equity fund sponsors and other alternative lenders also have formed private BDCs, or BDCs that do not offer their securities publicly, that raise capital from institutional and accredited investors.

BDCs are pass-through vehicles for tax purposes, and they are therefore not subject to an entity-level tax. A BDC may be internally or externally managed. Most BDCs are externally managed and the advisers to these entities receive base management fees (a percentage of the BDC's gross assets), as well as incentive, or performance, fees. Until recently, a BDC was prohibited from issuing a class of senior securities or paying any cash dividends unless the BDC had asset coverage of at least 200% (or a 1:1 debt-to-equity leverage ratio) immediately after the issuance or the dividend.[3]

SECURITIES REGULATIONS APPLICABLE TO BDCs

Historically, a public BDC will register to offer its securities under the Securities Act pursuant to a registration statement on Form N-2. Following its initial public offering, a BDC that lists a class of common equity securities on a national securities exchange will become subject to the reporting requirements under the Securities Exchange Act of 1934. The Form N-2 registration statement did not contemplate its use as a "shelf" registration statement for continuous or delayed securities offerings. Through no-action letter guidance, the SEC Staff has made a registration statement on Form N-2 available for use as a shelf registration statement to the extent that a BDC has been an Exchange Act-reporting company for at least 12 months and meets the other eligibility requirements for a primary offering on a registration statement on Form S-3. However, unlike registration statements on Form S-3 that allow incorporation by reference of information included in an issuer's Exchange Act filings to satisfy disclosure requirements in a registration statement, a registration statement on Form N-2 must be amended to update the registration statement with current information. A BDC also is subject to certain limitations relating to its use of the registration statement on Form N-2 as a shelf registration for delayed offerings.

A BDC may only complete offerings pursuant to a Form N-2 shelf registration statement to the extent that the cumulative dilution to the BDC's net asset value per share does not exceed 15%. To the extent that the cumulative dilution exceeds 15%, the BDC must file a post-effective amendment to the Form N-2, or file a new registration statement to include additional dilution tables and disclosures. As BDCs have become larger and more reliant on follow-on offerings conducted as

[2] Rule 2a-46 of the Investment Company Act.

[3] Section 61(a) of the Investment Company Act.

shelf takedowns, the limitations associated with the use of a registration statement on Form N-2 have become apparent.

Although, as noted above, BDCs are "hybrid" vehicles subject to certain provisions of the Investment Company Act, BDCs also have characteristics associated with operating companies. However, under the Securities Act, BDCs generally were not treated like operating companies. In 2005, as part of Securities Offering Reform, the SEC made significant changes to the provisions of the Securities Act applicable to securities offerings and to offering-related communications to facilitate capital formation.[4] For example, Securities Offering Reform identified certain categories of issuers, including seasoned issuers and well-known seasoned issuers ("WKSIs")[5] that are eligible to use a broader array of offering-related communications, such as free-writing prospectuses. The SEC also introduced the concept of automatic shelf registration for WKSIs, which are the largest, most sophisticated issuers. The Reform also introduced a number of communications safe harbors, providing greater certainty for issuers to engage in a broader range of communications without having such communications be considered "offers" under the Securities Act. Finally, the Reform introduced the concept of access equals delivery as a means of satisfying prospectus delivery requirements under the securities laws. While all of these changes facilitated capital formation for operating companies, and especially for WKSIs, the SEC chose not to extend these accommodations to BDCs or closed-end funds despite requests from commenters to do so. Instead, throughout the Securities Offering Reform adopting release, the SEC noted that BDCs and closed-end funds were subject to the framework established by the Investment Company Act, and it would be more appropriate to evaluate any changes in light of such framework.

Since 2005, there has been significant growth in the number of public BDCs. Perhaps because of this growth, and the considerable experience that the Staff has gained with such vehicles, the Staff's approach to BDCs has moderated. For example, after enactment of the Jumpstart Our Business Startups (JOBS) Act in 2012, which created a new category of issuer, the emerging growth company ("EGC"), and introduced changes to the initial public offering process for such issuers, a Staff interpretation noted that a BDC may qualify as an EGC.[6] As a result, a BDC that qualified as such would be able to benefit from the ability to submit the registration statement for its initial public offering for confidential review by the SEC Staff, test the waters with qualified institutional buyers and institutional accredited investors, and benefit from certain disclosure and corporate governance-related accommodations. In June 2017, after the Staff of the SEC's Division of Corporation Finance announced a policy extending the ability to submit for confidential review certain registration statements to issuers that did not qualify as EGCs, the Staff of the SEC's Division of Investment Management announced in March 2018 that this confidential submission process also would be available for BDCs that did not qualify as EGCs.[7]

LEGISLATIVE CHANGES AFFECTING BDCs

Although these developments were welcome, many BDCs and their advisers noted that the capital markets had changed significantly in recent years, but regulation of securities offerings by BDCs had not kept pace with these changes. Almost all follow-on offerings undertaken by public companies (including BDCs) now take the form of shelf takedowns, and most of these offerings are marketed on an accelerated basis in order both to avoid exposure to volatility and to take advantage of perceived opportunities to finance on favorable terms. However, the approach for securities offerings by BDCs — which limits their ability to use free- writing prospectuses, requires the filing and declaration of effectiveness of post-effective registration statements, and limits the availability of research safe harbors — makes it difficult for BDCs to finance efficiently. Limiting capital formation alternatives for BDCs, especially as BDCs have taken on a more important role as private capital providers to small- and medium-sized enterprises, has raised public policy concerns. A number of bills were introduced in recent sessions of Congress that would have amended the asset coverage, or leverage, requirements applicable to BDCs, and also would have required the SEC to harmonize the securities offering and communications requirements for

[4] Securities Offering Reform, SEC Rel No 33-8591 (July 19, 2015).

[5] Rule 405 of the Securities Act.

[6] Jumpstart Our Business Startups Act, Pub. L. No. 112-06, 126 Stat. 306 (Apr. 5, 2012). *See* question 21 of the Jumpstart Our Business Startups Act Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act, *available at* http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[7] *See* ADI 2018 - 01 – Expanded Use of Draft Registration Statement Review Procedures for Business Development Companies, *available at*: https://www.sec.gov/investment/adi-2018-01.

BDCs with those of operating companies. For a number of reasons, until just recently, these legislative efforts had failed to garner bipartisan support.

In March 2018, legislation known as the Small Business Credit Availability Act was included in an omnibus spending bill, the Consolidated Appropriations Act 2018, which was passed by Congress.[8] The Small Business Credit Availability Act amends the Investment Company Act by reducing the asset coverage requirement applicable to BDCs from 200% to 150%, or a 2:1 debt-to-equity leverage ratio.[9] The reduction in the asset coverage ratio must be approved either by the majority of a BDC's shareholders at a shareholders meeting at which a quorum is present or by a majority of the disinterested (independent) directors of the BDC and a majority of the directors who have no financial interest in the transaction.[10] If the reduction is approved by a shareholder vote, it is effective immediately. If the BDC seeks board approval, the reduction becomes effective one year following receipt of the approval. A BDC that obtains approval must disclose that it will rely on the increased leverage within five business days of its election to do so. It also must disclose in its Exchange Act filings the risks associated with increased leverage.[11] A BDC, the common equity of which is not listed or traded on a national securities exchange (referred to as a non-traded BDC), must offer its shareholders the opportunity to have their shares held at the approval date repurchased by the BDC following receipt of approval to increase its leverage. Shareholders electing to have their shares repurchased will have their shares repurchased in four equal quarterly payments, with 25% of the shares to be repurchased in each calendar quarter following such date.[12]

The Act also requires that the SEC amend its rules within one year of enactment in order to facilitate capital formation by BDCs by harmonizing the securities offering rules applicable to BDCs with those applicable to operating companies.[13] To the extent that the SEC does not amend its rules within the one-year period, BDCs will be able to rely on the securities and proxy rules as if such rules had been amended.[14] Effectively, the Act mandates that the SEC extend all of the benefits of Securities Offering Reform to BDCs as had been suggested by commenters back in 2005.

A BDC will no longer be considered an "ineligible issuer" and, as a result, will be able to use free-writing prospectuses.[15] A BDC also will be able to qualify as a WKSI, and file an automatically effective shelf registration statement on Form N-2 and avail itself of other benefits to which WKSIs are entitled.[16] Many BDCs have the common equity market value necessary to meet the WKSI criteria. For these BDCs, once the amendments become effective, raising capital will become much more efficient.

Form N-2 will be amended to allow for incorporation by reference, as does Form S-3.[17] Rule 415 also will be amended to make it applicable to offerings made pursuant to Form N-2 by issuers that meet the eligibility requirements for use of a registration statement on Form S-3.[18] Rule 497 will be amended to allow BDCs to file form prospectus supplements in a process resembling that available to operating companies relying on Rule 424.[19] As a result, a BDC that is a WKSI will be able to file an automatically effective shelf registration statement, benefit from satisfying disclosure requirements through incorporation by reference, and access the markets as opportunities present themselves, without having to wait for the SEC Staff to review and approve a new or a post-effective registration statement.

Rules 172 and 173, which allow for access equals delivery, will be applicable to BDCs.[20] This will eliminate the outdated process of having to print prospectuses and deliver physical copies of prospectuses to investors in BDC offerings.

BDCs will also be able to rely on various communications safe harbors under the Securities Act. Under the Securities Act, the notion of what constitutes

[8] Consolidated Appropriations Act, HR 1625, 115th Cong. (2018).

[9] Small Business Credit Availability Act is included as Title VIII of Division S of the Consolidated Appropriations Act.

[10] Section 61(a)(2) of the Investment Company Act.

[11] Section 61(a)(2)(A)-(C) of the Investment Company Act.

[12] Section 802. Section references are to the Small Business Credit Availability Act unless otherwise indicated.

[13] Section 803(b)(1).

[14] Section 803(d).

[15] Section 803(b)(2)(H) and 803(b)(2)(I).

[16] Section 803(b)(2)(A) and 803(c)(2). Many of the largest BDCs, such as, but not limited to, Ares Capital Corp., Golub Capital BDC, Inc., and Main Street Capital Corporation, would qualify as WKSIs.

[17] Section 803(c)(1).

[18] Section 803(b)(2)(J) and 803(b)(2)(P).

[19] Section 803(b)(2)(K).

[20] Section 803(b)(2)(L).

an "offer" of securities is broad, and, as a result, market participants have long been concerned that particular communications made in close proximity to securities offerings might be deemed offers. Over time, the SEC has established safe harbors for specific types of communications that provide some certainty that, if the identified conditions of the applicable safe harbor are met, the particular communications will not be deemed to constitute offers. As noted above, perhaps the most significant changes to the Securities Act communications framework were brought about by the Securities Offering Reform. As a result of this legislation, BDCs will have greater flexibility with respect to their ongoing business communications. For example, BDCs will be able to rely on Rules 168 and 169 under the Securities Act, which allow Exchange Act-reporting and non-reporting companies to disseminate regularly released factual business and forward-looking information even around the time of a securities offering without having such information be considered an "offer," so long as no reference is made to any potential offering.[21] Similarly, BDCs will be able to rely on the safe harbors under Rules 134, 163A and 163.[22] Rule 134 provides a safe harbor that allows issuers to make certain written statements regarding an offer after a prospectus is filed, provided certain conditions are met. Rule 163A provides a safe harbor from the Section 5(c) prohibition on pre-filing offers for communications that do not reference an offering, and that are made more than 30 days prior to the filing of a registration statement, provided certain conditions are met. Rule 163 provides a safe harbor from the Section 5(c) prohibition on pre-filing offers for WKSIs to engage in unrestricted oral and written communications before the filing of a registration statement, if certain conditions are met.

The research safe harbors provided by Rule 138 and Rule 139, which provide that certain reports are not considered offers under the Securities Act, will be applicable to BDCs. Rule 138 permits a broker-dealer participating in a securities offering to publish research reports about that issuer, if certain conditions are met. Rule 139 permits a broker-dealer participating in the distribution of securities of an issuer to publish research reports concerning that issuer or any class of its securities, if certain conditions are met.[23] It is important to note that other legislation, the Fair Access to Investment Research Act of 2017, the adoption of which preceded the enactment of the Small Business Credit Availability Act, had already mandated that the SEC provide a safe harbor for research reports that relate to certain registered investment companies, including exchange-traded funds, BDCs, and exchange-traded commodity-based or currency-based trusts or funds.[24] The SEC has proposed rules that would implement the mandate of the Fair Access Act by amending Rule 139; however, the changes that are required with respect to BDCs by the Small Business Credit Availability Act are broader.[25] These changes will facilitate more, and more timely, research coverage of BDCs.

Taken together, even if a BDC does not opt to rely on increased leverage, the collective impact of these changes will be significant and will reduce the ongoing securities compliance costs for a BDC, as well as facilitate access to the capital markets. In turn, this will mean that BDCs will have more funds to deploy for small-sized and medium-sized enterprises.

CLOSED-END FUNDS

The Economic Growth, Regulatory Relief and Consumer Protection Act, which was recently passed and focused principally on scaling back a number of Dodd-Frank Act-related rules and regulations affecting bank holding companies and banks, included Section 509, titled Parity for Closed-End Companies Regarding Offering and Proxy Rules (the "Parity Act").[26] As noted above, a BDC is a type of closed-end fund. A closed-end fund is an investment company that typically issues a fixed number of shares (unlike open-end, or mutual, funds that continuously offer their shares) in a public or private offering. A closed-end fund that conducts a registered public offering will register the offering pursuant to both the Securities Act and the Investment Company Act.[27] In recent years, closed-end funds have become more popular. They may be formed to pursue any number of investment objectives. As discussed above, the Securities Offering Reform did not allow closed-end funds to benefit from the offering and

[21] Section 803(b)(2)(B) and 803(b)(2)(G).

[22] Sections 803(b)(2)(C-E).

[23] Section 803(b)(2)(F).

[24] Fair Access to Investment Research Act of 2017, HR 910 (Oct. 6, 2017).

[25] Covered Investment Fund Research Reports, SEC Release 33-10498.

[26] Economic Growth, Regulatory Relief and Consumer Protection Act, Pub. L. No. 115-174 (2018).

[27] Section 5(a)(2) of the Investment Company Act.

communications related improvements brought about by the measure. The Parity Act requires that within one year of enactment, the SEC propose, and no later than two years following enactment, the SEC adopt, final rules that extend to closed-end funds the securities offering and proxy rules available to operating companies under the Securities Act. If the SEC fails to take action within the specified time to complete its rules, the amendments shall be deemed effective.

CONCLUSION

Following adoption of the required amendments described in this article, there will no longer be any distinction between the offering and communications-related rules applicable to operating companies and those applicable to BDCs and closed-end funds. While these changes may seem overdue to many actively engaged with hybrid funds, they are nonetheless welcome and will promote capital formation. Beyond undertaking the rulemaking mandated by Congress as a result of these legislative measures, the SEC might do well to consider, in light of its own mission of promoting capital formation, whether a Securities Offering Reform 2.0 may benefit issuers generally. Given that the 13 years since adoption of Securities Offering Reform have been characterized by significant technological advances, increased reliance on social media, and changes in the ways that already public companies raise capital, revisiting the framework governing securities offerings and related communications would be a useful and timely exercise. ■