Market Trends 2018/19: Business Development Companies

A Lexis Practice Advisor® Practice Note by
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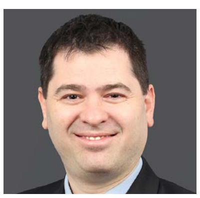

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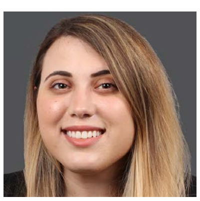

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Business development companies (BDCs) are closed-end investment management companies that are specially regulated by the Investment Company Act of 1940, as amended (the 1940 Act). BDCs provide capital to, and invest in, small and middle-market companies in the United States. As a result of this 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., the entity is not taxed at the entity level and tax obligations pass to the owners of the entity). This market trends article covers recent commercial and regulatory trends affecting BDCs, particularly focusing on various types of securities offerings by public and private BDCs.

To be regulated as a BDC, a company must elect to be subject to the provisions of Sections 55– 65 of the 1940 Act. Given the limited access to, and availability of, financing from traditional bank lenders for small and medium-sized enterprises, BDCs have played an increasingly important role since the onset of the financial crisis as a source of capital to small and mid-sized enterprises.

In addition to being subject to the 1940 Act, the securities issued by BDCs 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 BDCs are subject to the registration and reporting requirements under those two regulations. For additional information on BDCs, see Business Development Companies.

Notable Transactions

In November 2018, Bain Capital Specialty Finance (NYSE: BCSF), a BDC externally managed by a subsidiary of Bain Capital Credit, LP, consummated an initial public offering (IPO). The IPO priced at $20.25 per share raising approximately $151.9 million in gross proceeds. BofA Merrill Lynch, Morgan Stanley, Goldman Sachs & Co. LLC, Citigroup, Credit Suisse, Wells Fargo Securities and Keefe, Bruyette & Woods, A Stifel Company acted as joint book-running managers for the IPO. BCSF's primary focus is investing in middle-market companies with between $10.0 million and $150.0 million in annual earnings before interest, taxes, depreciation, and amortization. As part of the IPO, BCSF's investment adviser agreed to pay 50% of the total sales load due to the underwriters and 50% of the offering expenses incurred by the BDC in connection with the offering. BCSF was not obligated to repay its investment adviser for those expenses in the future. Additionally, upon consummation of the IPO, individuals affiliated with Bain Capital adopted a Rule 10b5-1 trading plan allowing the participants to buy up to $20 million of BCSF's common stock in the open market following the offering. For further information on 10b5-1 plans, see Rule 10b5-1 Plans and 10b5-1 Plans Best Practices Checklist.

Deal Structure and Process

Initial Public Offerings (IPOs)

Recently, the number of BDC IPOs has stagnated and the private BDC has emerged as a popular alternative for sponsors seeking to access the BDC structure.

To undergo an IPO, a BDC must register its securities on Form N-2. Form N-2 should describe the terms of the IPO (including the amount of shares being offered, underwriting arrangements, and price); intended use of proceeds, any risk factors associated with investing in a BDC; details about management of the BDC; and investment policies and objectives. In addition, the registration statement must include financial statements pursuant to the requirements in Regulation S-X.

In advance of its IPO, if a BDC has identified potential portfolio companies, but has not yet purchased such portfolio companies, the Form N-2 must still describe the BDCs general criteria for identifying portfolio companies and must also describe the identified portfolio companies generally. If a BDC owns a particular portfolio company at the time of the IPO, then the registration statement must identify the portfolio company and also provide the following details:

- The nature of the portfolio company's business
- The general terms as well as the amount of all loans given to the portfolio company
- The relationship of the portfolio company to the BDC –and–
- The class, title, and percentage of class and value of any securities of the portfolio company in possession of the BDC

Shelf Offerings

The use of the shelf registration statement process has proven 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 the capital markets when needed or when market conditions are optimal. The shelf registration statement can be filed with the 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 receipt of 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 filing date. Takedowns from an effective shelf registration statement can then be consummated without SEC staff review or delay. For further information on shelf registration, see Shelf Registration, Market Trends 2017/18: 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.

BDCs typically use shelf registration statements to issue debt and equity securities. Debt securities are issued by BDCs from time to time either in stand-alone offerings or as 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, which are aimed at retail investors, are referred to as baby bonds due to their small face amount). 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 pursuant to its shelf registration statement, which rights allow the holder to receive voting securities even when the BDC's 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 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

Given the recent securities offering reforms detailed below, ATM offerings are likely to become a more cost-efficient alternative for BDCs seeking to raise capital. An ATM offering is an offering of securities into a BDC's existing trading market for outstanding shares of the same class at other than a fixed price (1) executed on, or through the facilities of, a national securities exchange; or (2) 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 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.

Private BDCs

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

Private BDCs are usually sponsored or formed by parent private equity firms or financial institutions that already have the necessary preexisting 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 under 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 as 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 that is typically subject to a shorter review period by the SEC. For additional information on Form 10, see Form 10 Drafting.

On May 30, 2018, the SEC's Division of Investment Management issued an exemptive order that permits a private BDC to conduct an exchange offer pursuant to which BDC investors, including directors and officers of the BDC, may elect to exchange their BDC shares for shares in a new split-off extension fund. The new split-off extension fund would receive a pro rata portion of the BDC's assets and liabilities, including each of the BDC's portfolio investments, in proportion to the percentage of the BDC shares exchanged. Relief from the Division was required to allow the BDC's investment adviser to also act as the investment adviser of the new split-off extension fund and avoid potentially triggering common control prohibitions under the 1940 Act. As private BDCs do not have publicly traded shares, this new exchange option is expected to provide private BDC investors with a liquidity opportunity following the extension fund's IPO.

Legal and Regulatory Updates

Small Business Credit Availability Act

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. Various portions of the Small Business Credit Availability Act were automatically effective following the one-year anniversary of the Act. The Act also reduced the asset coverage requirement applicable to electing BDCs from 200% to 150%. This reduction allows electing BDCs to maintain a maximum 2:1 debt-to-equity leverage ratio. Increasing the leverage limit may allow BDCs 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 board of directors or shareholders of numerous BDCs, including Ares Capital, Apollo Investment, Goldman Sachs BDC, Hercules Capital, New Mountain Finance, PennantPark Floating Rate Capital, Solar Capital, and TCG BDC, have approved the reduced 150% asset coverage level. However, others, including Owl Rock Capital, have decided to maintain the 200% asset coverage level.

Certain BDCs 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. As a result, many BDCs entered into new financing arrangements to increase the availability of debt relative to equity. For instance, PennantPark Investment Corp. recently entered into a new $250 million revolving credit facility. The terms of the new credit facility allow the BDC to operate within the new lowered asset coverage requirement. Additionally, Oaktree Specialty Lending Corp. recently announced an increase in its ability to borrow under its senior revolving loan facility and also an automatic reduction in the asset coverage requirement under the facility in the event that it becomes applicable to the BDC. Bain Capital Specialty Finance also recently announced an agreement to lower its asset coverage requirement to 150%.

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. In early 2019, Fitch Ratings released a report setting forth a negative outlook for BDCs due to the change in the asset coverage requirement. The report predicted a gradual increase in leverage for BDCs in 2019.

Securities Offering Reforms

In March 2019, the Securities and Exchange Commission (SEC) proposed rule amendments that are intended to address the mandate in the Small Business Credit Availability Act that the SEC modernize the offering-related provisions and the communications safe harbors available to BDCs under the Securities Act. The SEC also proposed accompanying amendments to Form N-2, which is the form BDCs must use to offer securities. These proposed amendments are welcome given that historically the offering process for these entities has been cumbersome and has impaired access to capital formation. The proposed changes are subject to a 60-day comment period. After the comment period closes and once the amendments become effective, raising capital will become much more efficient for BDCs.

The proposing release included harmonization provisions for closed-end funds (CEFs) as well. While many of the proposed amendments cover both BDCs and CEFs, there are a few notable differences. For example, CEFs that operate as interval funds would be able to register an indefinite number of shares, rather than a particular amount, and pay registration fees in accordance with the net issuance of the shares, rather than at the time of filing. In addition, and as already required for BDCs, CEFs would need to include a section covering management's discussion of fund performance in their annual reports as well as file current reports on Form 8-K.

Among the most important proposed changes for BDCs would be (1) the ability to qualify as well-known seasoned issuers (WKSIs) to the extent that the entities meet the reporting history and float requirements for WKSI status, (2) the ability for other seasoned BDCs that do not qualify as WKSIs to use more streamlined shelf registration statement procedures, and (3) the ability to rely on a number of important communications safe harbors.

WKSI Status

A BDC will no longer be considered an ineligible issuer and, as a result, will be able to qualify as a WKSI, file an automatically effective shelf registration statement, and use free writing prospectuses. Many BDCs already meet the public float requirement ($700 million) for WKSI status. For further information, see WKSIs and Seasoned Issuers.

Incorporation by Reference

Form N-2 will be amended to allow for incorporation by reference in the same manner as Form S-3. A BDC that meets the Form S-3 eligibility requirements would be able to backward incorporate and forward incorporate subsequently filed Exchange Act documents. BDCs meeting the Form S-3 eligibility requirements also will be able to rely on Rule 430B in order to omit certain information from their registration statements and rely on the prospectus to provide the omitted information. Rule 497 will be amended by the SEC to allow BDCs to file form prospectus supplements in a process resembling that available to operating companies relying on Rule 424. For further information, see Rule 424 Prospectus Supplements Filing.

Access Equals Delivery

Rules 172 and 173 under the Securities Act, which permit access equals delivery, will become applicable to BDCs. The prospectus and incorporated materials would be required to be made available on a website. This will eliminate the outdated process of having to print prospectuses and deliver physical copies of prospectuses to investors in BDC offerings.

Communications Safe Harbors

BDCs will be able to rely on Rules 168 and 169 under the Securities Act, which allow 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 and the other conditions of the safe harbors are met.

BDCs will also be able to rely on the safe harbors under Rules 134, 163A, and 163 under the Securities Act. 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.

Relatedly, and as required by a different statute, on November 30, 2018, the SEC adopted a new rule establishing a nonexclusive research report safe harbor, Rule 139b, under the Securities Act for unaffiliated brokers or dealers that publish or distribute research reports regarding BDCs. The safe harbor is available even if the broker-dealer is participating in or may participate in a registered offering of the BDC's securities. Adoption of this safe harbor reduces obstacles that previously prevented investors from accessing research reports on BDCs given that, prior to these changes, the research safe harbors were not available to BDCs and broker-dealers generally refrained from publishing research reports about BDCs in proximity to securities offerings for such entities.

No-Action Letter and Other SEC Staff Guidance

On February 28, 2019, the Staff of the SEC's Division of Investment Management (the Staff) issued a no-action letter 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 position softens, but does not eliminate, the burden for BDCs and their boards to adhere to certain in-person voting requirements. For example, 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.

On December 19, 2018, the SEC proposed a new rule (Rule 12d1-4) that is intended to modernize and improve the regulatory framework for fund of funds arrangements. The proposed rule would permit BDCs to acquire the securities of any registered investment company or BDC in excess of the limits in Section 12(d)(1) of the 1940 Act subject to compliance with certain conditions. BDCs holding more than 3% of a fund's outstanding voting securities would be required to vote those securities in a prescribed manner and would be prohibited from redeeming more than 3% of the fund's outstanding shares during any 30-day period.

On November 14, 2018, the Staff released frequently asked questions relating to the investment company reporting modernization reforms. The reforms included revisions to Regulation S-X requiring BDCs to include a standardized schedule containing detailed information about derivative instruments in their financial statements.

On October 12, 2018, the Staff issued a no-action letter that allows a BDC's board of directors to rely upon quarterly compliance certifications from the BDC's chief compliance officer that address the BDC's compliance when the BDC is engaging in certain affiliate transactions under the 1940 Act instead of requiring the board of directors itself to determine compliance.

On September 7, 2018, the Staff issued a no-action letter that allows a registered investment adviser to issue collateralized loan obligations through a BDC in order to satisfy obligations under the risk retention rules without violating the 1940 Act's restrictions on affiliate transactions.

On March 16, 2018, the Staff announced that it will 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 accept for non-public, confidential review draft registration statements relating to offerings that are submitted by BDCs within one year of an IPO.

Market Outlook

Many BDC industry participants have recommended that the Staff 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.

On September 4, 2018, The Coalition for Business Development, Apollo Investment Management, L.P., and Ares Capital Management LLC submitted an application requesting that the SEC issue an exemptive order exempting BDCs from the AFFE disclosure requirement. Additionally, on December 19, 2018, as part of the proposing release for Rule 12d1-4, the SEC formally requested industry suggestions to improve AFFE disclosure. The BDC market would likely be receptive if the SEC were to take action with respect to AFFE disclosure in 2019.

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Anna Pinedo is a partner in Mayer Brown's New York office and a member of the Corporate & Securities practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

Brian D. Hirshberg, Counsel, Mayer Brown LLP

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.

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Julia T. Spinelli is an associate in Mayer Brown's New York office and a member of the Corporate and Securities practice. She focuses on securities and corporate finance transactions, as well as general corporate counseling.

Julia advises issuers, investment banks, sponsors and investors in both public and private placements of equity and debt securities, including follow-on offerings, at-the-market offerings, medium and senior term note programs, investment-grade debt offerings and other capital market transactions.

Julia earned her JD from Fordham University School of Law, where she received the Mark W. Kenny Memorial Scholarship. While in law school, Julia was the Editor-in-Chief of Volume XLI of the Fordham International Law Journal.

Julia graduated from Swarthmore College. She earned her Bachelor of Arts degree with a double major in Psychology and Film & Media Studies and was a four-year member of the Women's Varsity Field Hockey team.