Business Development Company Guide for Capital Markets

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This guide covers all related information that a securities practitioner needs when working with a Business Development Company (BDC). It provides an overview of the industry and covers applicable securities laws and regulations, securities offering process, disclosure and corporate governance obligations, stock exchange requirements, commercial and regulatory trends, and practical tips for counsel.

Overview of BDCs

BDCs are closed-end investment management companies that are specially regulated by the Investment Company Act of 1940, as amended (the 1940 Act). 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. BDCs provide capital to, and invest in, small and middle-market companies in the United States. 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 (i.e., where the entity is not taxed, and the tax is passed on to the owners of the entity). 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.

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 is one that 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 of 1933, as amended (the Securities Act). 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 accredited investors. Notwithstanding the absence of a public securities offering, the private BDC must still comply with the Securities Exchange Act of 1934, as amended (the Exchange Act), reporting requirements similar to its public company BDC peers because it is required to register under the 1940 Act.

The BDC industry has a number of major players. The BDC with the largest market capitalization and total assets is Ares Capital Corporation, a Nasdaq-listed BDC that helps finance middle-market companies in a variety of industries, including healthcare, restaurants, power and real estate. FS KKR Capital Corp. is another BDC with large market capitalization and total assets; it provides financing to private middle-market companies in the United States and its common stock is traded on the NYSE. Apollo Investment Corporation (Apollo) has a $2.31 billion investment portfolio and its common stock is traded on Nasdaq. Approximately 20% of

Apollo's portfolio is invested in the aviation and consumer transport industries.

For further information on BDCs, see Business Development Companies, Top 10 Practice Tips: Business Development Companies and Market Trends 2018/19: Business Development Companies.

Applicable Securities Laws and Regulations

In addition to registration under the 1940 Act, BDCs and their securities are typically also registered under the Securities Act and the Exchange Act and are subject to the registration and reporting requirements under those two Acts. For general information, see U.S. Securities Laws and Liability under the Federal Securities Laws for Securities Offerings.

1940 Act

The 1940 Act defines a BDC as a domestic closed-end company that operates for the purpose of making investments in the securities specified in Section 55(a) of the 1940 Act. In addition, a BDC makes available significant managerial assistance to the issuers of the types of securities specified in Section 55(a). A BDC must also elect BDC status under the 1940 Act pursuant to Section 54(a). Electing such status subjects the BDC to Section 55 through 65 of the 1940 Act. The 1940 Act also sets forth specific criteria that require a BDC to maintain at least 70% of its investments in eligible assets before investing in non-eligible assets. A BDC is subject to certain ongoing requirements of the 1940 Act. For example, under Section 56(a) of the 1940 Act, the majority of directors of a BDC cannot be interested persons. Section 17(j) of the 1940 Act requires adoption of a written code of ethics. BDCs are also required to implement compliance procedures under the 1940 Act. The 1940 Act requires a majority of the BDC's board to approve such compliance procedures and also requires the appointment of a chief compliance officer. Finally, Section 31 sets forth the recordkeeping requirements for a BDC.

For further information on the 1940 Act, see Investment Company Act of 1940 Exemptions and Exceptions.

Investment Advisers Act of 1940

A BDC can be externally or internally managed. If externally managed, a BDC must enter into an investment management agreement with its manager. This agreement will be subject to board approval and shareholder approval under the 1940 Act. In addition, the investment adviser must also register under the Investment Advisers Act of 1940 (the Advisers Act). Registration as an investment adviser under the Advisers Act requires, among other things, the adoption of a compliance program and the appointment of a chief compliance officer, as well as the adoption of a code of ethics that will apply to directors, officers and investment personnel. For more details on the registration process, see Investment Adviser Registration Process.

Securities Act

The Securities Act governs the offer and sale of securities in the United States. The Securities Act requires that a registration statement be filed with the Securities and Exchange Commission (SEC) for the public offer and sale of securities. In order to register an offering under the Securities Act, a BDC must register its securities on Form N-2. Form N-2 requires a description of the terms of the offering (including the amount of shares being offered, underwriting arrangements and price), intended use of proceeds, risks associated with investing in the BDC, details about management of the BDC and a description of the BDC's investment policies and objectives.

For more information on registered offerings, see Registered Offerings: Applicable Laws, Rules, and Regulations, Initial Public Offerings Resource Kit, Top 10 Practice Tips: Initial Public Offerings, Top 10 Practice Tips: Follow-on Offerings, and Follow-On Offerings Resource Kit.

Exchange Act

In addition to the requirements set forth in the Securities Act, BDCs are subject to a number of reporting requirements under the Exchange Act. After electing to be classified as a BDC, a BDC must register a class of securities under Section 12 of the Exchange Act. See Registration Requirements under Section 12 of the Exchange Act. In addition, BDCs are subject to periodic reporting requirements and, as such, must file reports, such as Form 10-Ks, 10-Qs and 8-Ks. Further, BDCs are required to file proxy statements under Section 14(a) of the Exchange Act. See Public Company Periodic Reporting and Disclosure Obligations, Top 10 Practice Tips: Periodic and Current Public Company Reporting, and Periodic and Current Reporting Resource Kit.

Securities Offering Process

Set forth below is a brief summary of the typical process for initial and follow-on offerings.

Formation as a BDC and Formation Transactions

As discussed above, in order to be regulated as a BDC, a company must elect to be treated as such under Section 54(a)

of the 1940 Act. To elect to be treated as a BDC, a company files a Form N-6, which is the intent to file a notification of election before filing a Form 54A, which is the form electing to be regulated as a BDC.

Under the 1940 Act, a BDC is subject to ongoing requirements following its election to become a BDC. For example, a BDC must maintain a bond issued by a fidelity insurance company, which will protect the BDC against larceny and embezzlement. The amount of coverage under the bond depends on the BDC's assets. Every officer and employee who has access to funds and securities must be covered by this bond.

If a BDC is externally managed, it must enter into an agreement with a third party who will provide it with investment advisory services. This agreement is subject to certain requirements under the 1940 Act. The agreement must have board approval initially and the board must approve the agreement annually following its initial adoption. In addition, the agreement must garner shareholder approval as well. Finally, as discussed above, external investment advisers are also subject to the regulatory requirements set forth by the Advisers Act.

There are various types of formation transactions that may be undertaken in order to launch a BDC. For example, acquiring an existing private fund or small business investment company (SBIC) is a common approach. SBICs operate under a license granted by the Small Business Association that allows an SBIC to borrow up to $150 million from the U.S. Government. The loan is in the form of an SBA debenture and allows the SBIC to invest in the debt of small business issuers. The 1940 Act allows a BDC to own an SBIC and exclude the SBIC's leverage from the BDC's own leverage limits. Fidus Investment Corporation is a large BDC that once operated as an SBIC and converted into a BDC.

Another common formation transaction is structured such that an affiliate fund sells its assets to the BDC in exchange for cash. This option allows management to retain the current assets and grow them through the BDC vehicle. Given this formation transaction involves affiliated parties, it must specify in the legal agreements that the sale is for cash rather than an equity stake in the BDC. This is necessary due to the restrictions on affiliated transactions upon election as a BDC. Alcentra Capital Corporation (Alcentra) was formed using this approach. Alcentra purchased a portfolio of approximately of $150 million in debt and equity investments from BNY Mellon-Alcentra Mezzanine III, L.P. in exchange for cash and shares of common stock at the IPO price. It also purchased $29 million of debt and equity holdings from BNY Alcentra Group Holdings, Inc. under a warehouse facility. Alcentra then entered into a loan agreement with ING Capital LLC in order to fund the warehouse portfolio purchase as well as the cash portion of the transaction with BNY Mellon-Alcentra Mezzanine III, L.P. Once Alcentra received proceeds from its IPO, it repaid the loan from ING Capital LLC.

Another common formation transaction is the contribution of assets from an affiliated fund in exchange for equity interests in the new BDC. This approach was taken by Golub Capital, BDC, Inc., WhiteHorse Finance, Inc. and Garrison Capital Inc.

Initial Public Offering (IPOs)

To undertake an IPO, a BDC must register its securities on Form N-2. If in advance of its IPO, a BDC has identified potential portfolio companies, but has not yet purchased such portfolio companies, the Form N-2 must still describe the BDC's general criteria for identifying portfolio companies and must also describe the identified portfolio companies generally. If a BDC owns an interest in 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 made 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 held by the BDC.

For more information on registered offerings and IPOs, see Registered Offerings: Applicable Laws, Rules, and Regulations, Initial Public Offerings Resource Kit, Top 10 Practice Tips: Initial Public Offerings, Top 10 Practice Tips: Follow-on Offerings, and Follow-On Offerings Resource Kit.

Key Documents

Base Prospectus

Once a BDC is a public reporting company and eligible to use a shelf registration statement, it will file on Form N-2. A Form N-2 used as a shelf registration statement will usually include a base prospectus, which is a document that describes the type of securities that may be offered pursuant to the shelf registration statement. After all comments have been resolved and the registration statement amended, the BDC may submit an acceleration request to have the shelf registration be declared effective by the SEC. For more information on the process, see IPO Prospectuses: Avoiding and Responding to Common SEC Comments.

Underwriting Agreement

The underwriting agreement is the main agreement in connection with a public offering of securities. It sets forth the relationship between the issuer and the underwriters,

typically acting in a syndicate. While there may be many underwriters participating in the deal, typically three or four underwriters will act as representatives for the syndicate and actually sign the agreement. Typical underwriting arrangements and provisions are discussed below. For practical tips on how to negotiate an underwriting agreement, see Top 10 Practice Tips: Negotiating an Underwriting Agreement. For more details on underwriting agreements used in public offerings, see Underwriting Registered Securities Offerings.

Lock-up Agreements

In an equity offering, lock-up agreements are often required by the underwriting agreement and these agreements restrict a company's directors, officers and often its existing stockholders from selling their company securities for a specified period of time after the public offering. The purpose of a lock-up agreement is to minimize any disruption in the trading market for the company's securities. The lock-up period for most BDC IPOs is 180 days. The lock-up agreement is almost always included as a form in the underwriting agreement. For more information on lock-up agreements, see Market Trends 2017/18: Lock-up Agreements and Top 10 Practice Tips: Lock-Up Agreements.

Comfort Letters

Pursuant to the underwriting agreement, the company's independent auditors must deliver a comfort letter to the underwriters typically upon the execution of the underwriting agreement. The comfort letter affirms the auditor's independence from the company and sets forth the specific accounting procedures undertaken in connection with the preparation of, and the audit of or review of, the company's financial statements, as well as certain agreed-upon procedures in relation to information included in, or incorporated by reference into, the applicable prospectus. For more information regarding comfort letters, see Comfort Letters and for practical tips, see Top 10 Practice Tips: Comfort Letters.

Due Diligence

There are a number of important documents to review as part of the due diligence process. These documents include basic corporate documents, including board meeting minutes, financial information, portfolio company investments, financing arrangements, co-investments or joint transactions, valuation information, litigation matters, and information about directors and officers. As part of the offering, underwriters' counsel may prepare a due diligence list requesting specific documents.

In connection with a BDC IPO, the diligence process will necessarily be more intensive and will include a review of certain fundamental agreements, including the investment advisory agreement and the administration agreement. The advisory agreement must be approved by the board initially upon adoption and annually thereafter. When evaluating the fee as part of the investment advisory agreement renewal, the board of directors must consider the independence, care and expertise of the board of directors in evaluating the advisory fee, the quality and nature of the services being provided to the BDC, the profits realized by the adviser through its relationship with the BDC, whether or not economies of scale, if present, are shared with investors, fee structures of similar entities and fall-out benefits to the adviser. Diligence should also include an analysis of any applicable no-action letter relief from the Division of Investment Management (the Staff) of the SEC. A no-action letter is a letter written by the Staff to a BDC that indicates that the Staff does not recommend that the SEC take legal action against a requesting BDC. The no-action letter is in response to a request for relief by a BDC. BDCs are limited in their ability to undertake transactions with related parties, which includes affiliates under the 1940 Act (discussed below). Affiliates cannot engage in certain types of transactions with related parties such as, co-investments, joint exits and joint restructurings and having a broker-dealer affiliate serve as principal underwriter. While BDCs may seek no-action or exemptive relief from the Staff of the SEC for co-investments as well as joint exits and joint restructurings, diligence efforts should focus on whether an affiliate relationship exists.

Further, under the 1940 Act, a BDC must adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. As part of these policies, BDCs must have valuation policies in place to assess accurately the value of their portfolio holdings. These valuation procedures must be approved by the BDC's board of directors. BDCs must mark the loan portfolio to fair value on a quarterly basis for financial statement purposes and any unrealized gains or losses must be reflected. Fair value is determined by the BDC's board of directors and management, typically working together with both third-party valuation firms and internal auditors. During diligence, it is important to review the BDC's valuation policy to ensure that it complies with industry standards, as well as with the requirements under the 1940 Act. In addition, any valuation opinions or reports should be reviewed to ensure that the BDC is complying with valuation standards.

The diligence process also should include a thorough analysis to ensure that a BDC's adviser complies with applicable Advisers Act requirements.

For more information on due diligence, see Due Diligence for Securities Offerings Resource Kit, Due Diligence Interviews, and Top 10 Practice Tips: Due Diligence for Securities Offerings.

Disclosure Obligations

Risk Factors

There are a number of risks common to BDCs that are disclosed in public filings. Risks that are often addressed include the following:

- The lack of public trading of the portfolio investments, which makes it difficult to assess the fair value of the investments.
- Conflicts of interest that could impair returns on investments.
- Limitations on co-investment.
- Inability to fund below net asset value (NAV).
- Reliance on the external manager to retain key personnel.
- Competitiveness of the investment market.
- Increased risk in investing in the BDC following the reduction in asset coverage ratio from 200% to 150%.
- Loss in BDC status resulting in the entity being regulated as a closed-end investment company under the 1940 Act and losing the exemptions afforded to BDCs.
- Risks related to LIBOR exposures.

For additional information, see Market Trends 2016/17: Risk Factors, Top 10 Practice Tips: Risk Factors and Risk Factor Drafting for a Registration Statement.

MD&A and Business

The MD&A is required by the SEC and must be included in a public company's annual and quarterly filings. For MD&A requirements, see Management's Discussion and Analysis of Financial Condition and Results of Operations and Management's Discussion and Analysis Section Drafting Checklist. The MD&A includes management's assessment of the company's financial performance as well as the trends that may impact future performance. For BDCs, this section typically includes an overview of portfolio and investment activity. This section often discusses the fair market value of the portfolio company investments, the distribution of the investments based on credit ratings, investment income, operating expenses (including management fees and incentive fees paid to an external manager, if any), terms of the investment management agreement, valuation of portfolio investments and tax considerations.

Other Prospectus Disclosure

As discussed above, a BDC must disclose detailed information about a proposed offering when registering the offer of its securities on Form N-2. Additionally, the BDC must include information about both prospective portfolio company investments as well as interests in portfolio companies.

On October 13, 2016, the SEC adopted a new reporting regime for registered investment companies. While BDCs are not required to register under the 1940 Act, they do elect to be subject to certain provisions of the 1940 Act as discussed above. The amendments to Article 6 and Article 12 of Regulation S-X are applicable to BDCs. Previously, Regulation S-X did not require certain information to be included about the majority of derivatives. The amendments now require that any investment in derivatives by a BDC be prominently disclosed in the BDC's schedule of investments as opposed to contained in the notes to the financial statements. Further, the amendments changed the disclosure requirements for transactions with affiliates of the BDC, such as investments in the affiliate and advances to the affiliate.

Additional Disclosure Issues

BDCs are subject to a number of ongoing reporting requirements. BDCs must file periodic reports under the Exchange Act as well as proxy statements under Section 14(a) of the Exchange Act. Further, management of the BDC must report any ownership interest in the securities of the BDC and these transactions are subject to the short swing profit rules.

Underwriting Agreements

Types of BDC Offerings

There are various types of offerings that have proven particularly useful for public BDCs. First, a shelf offering is helpful for BDCs that trade at a premium to NAV for only a short, and typically unpredictable, period of time. Having an effective shelf registration statement enables a BDC to access the capital markets when needed or when market conditions are favorable. The shelf registration statement can be filed with the SEC and reviewed while the BDC's common stock 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 may be 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.

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 pursuant to 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 in takedowns from medium-term note 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 small face amounts). 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. For more information, see Market Trends 2018/19: Shelf Registrations and Takedowns and Shelf Registration.

In addition to the types of securities offerings mentioned above, a BDC may also issue rights pursuant to its shelf registration statement that allow the holder to subscribe for 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.

ATM offerings are becoming increasingly used as a cost-efficient alternative for BDCs seeking to raise capital. An ATM offering is an offering of securities into the existing trading market for that class of securities 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 the price is based on the trading price of the securities. An ATM, or 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. For recent ATM trends, see Market Trends 2018/19: At-the-Market Equity Offerings. For practical tips on ATM offerings, see Top 10 Practice Tips: At-the-Market Offerings.

Underwriting Arrangements

As discussed above, the underwriting agreement is the main document used for the public offering of securities. The underwriting agreement for a BDC will usually include a representation on the part of the company that it meets the eligibility requirements for Form N-2 and, in addition, that the offering documents do not contain material misstatements or omissions.

There are many underwriting provisions which are specific to BDCs. First, many underwriting agreements for BDCs include a provision stating that to the BDC's knowledge, each portfolio company is current in all material respects with all of its obligations under the applicable portfolio company agreements. Further, this provision typically states there have been no events of default under such portfolio company agreements. The provision contains a qualifier mentioning that any such failure on the part of the portfolio company to be current in its obligations or any event of default not reasonably expected to result in a material adverse effect (as defined in the underwriting agreement) are exempt from this representation. Underwriting agreements for BDC offerings typically contain a representation that the terms of the advisory agreement comply in all material respects with the applicable provisions of the 1940 Act and Advisers Act and that the necessary approvals from the BDC's board of directors and stockholders have been obtained in accordance with Section 15 of the 1940 Act. Further, cybersecurity representations on the part of the company are becoming increasingly common in all underwriting agreements, not just those of BDCs. This representation essentially states that the company has appropriate controls in place to protect against a cybersecurity breach and that there has not been a breach of the company's systems.

Another issue that typically comes up when drafting underwriting agreements for BDC offerings is whether the advisor and BDC are making representations and providing an indemnity to the underwriters on a joint and several basis (this is the most common approach).

Similar to most non-BDC underwriting agreements, underwriting agreements for BDCs will also typically include a provision addressing the payment of expenses. In many instances, the clause will specify that the BDC will pay all

expenses incident to the performance of its obligations under the underwriting agreement. Finally, and as discussed more fully above, certain of the BDC's executive officers and directors are subject to a lock-up period during which these executive officers and directors cannot sell their shares.

Continuous Disclosure and Corporate Governance

There are a number of ongoing reporting obligations and governance matters that must be addressed by BDCs. Under the Exchange Act, a BDC must file periodic (Form 8-K), quarterly (Form 10-Q) and annual reports (Form 10-K) and proxy statements. Further, certain holders of securities of BDCs must make Section 13 and Section 16 filings. Forms 3, 4 and 5 are used to report beneficial ownership by insiders. Schedules 13D and 13G are used for reporting beneficial ownership by others.

Directors are responsible for the valuation of the portfolio holdings in the absence of readily available market values under the 1940 Act. Given that a BDC must report its NAV quarterly, board meetings must be held in conjunction with the filings of each Form 10-Q and Form 10-K so that the proper board approval can be garnered for such valuations. Further, under the 1940 Act, investment advisory agreements must be approved annually by the board of directors. As a further requirement, these approval meetings generally must be in person. The advisors that are parties to these investment advisory agreements must comply with the Advisers Act. Finally, under the 1940 Act, there must be a majority of independent directors. For purposes of the 1940 Act, this means persons who are not interested persons pursuant to Section 2(a)(19) of the 1940 Act. Such interested persons include, but are not limited to, affiliated persons, an immediate family member of an affiliated person, any interested person of any investment advisor or principal underwriter and any person, partner or employee of any person who at any time in the last two completed fiscal years has acted as legal counsel for the BDC.

While the independent directors of the BDC will have all of the responsibilities and liabilities associated with independent directors of public companies, they also have enhanced duties that are unique to BDCs. First, with traditional investment companies, joint transactions with affiliates are often not allowed. However, as discussed below, BDCs may undertake joint transactions with second-tier affiliates so long as approved by the BDC's independent directors. Further, BDCs often are granted no-action relief or exemptive relief from the SEC that permit them to co-invest with affiliates of the BDCs' external manager. The independent directors are responsible for ensuring that the conditions of any exemptive order is strictly observed. Independent directors are responsible for valuation of the portfolio holdings as discussed above.

Public BDCs must also comply with the corporate governance and other requirements of the Sarbanes-Oxley Act (SOX). Under SOX, management is required to document internal controls as well as test internal controls. Further, auditors must evaluate those control procedures completed by management.

See Public Company Periodic Reporting and Disclosure Obligations, Top 10 Practice Tips: Periodic and Current Public Company Reporting, and Periodic and Current Reporting Resource Kit.

Stock Exchange Requirements

Special Listing Standards

NYSE

Rule 102.04B of the NYSE Listed Company Manual sets forth the initial listing standards for BDCs, which are largely the same as the general non-BDC listing requirements. The only requirement unique to BDCs is that to list initially on the NYSE, a BDC must have either $75 million in global market capitalization or the market value of the shares to be publicly held must be $60 million.

Nasdaq

Rule 5315(d) makes reference to the initial listing requirements for equity securities of a BDC on the Nasdaq Global Select Market, which are largely the same as the general listing requirements. However, BDCs do not have to meet the valuation requirements set forth in Rule 5315(f)(3) and instead must have a market value of listed securities of at least $80 million.

For more information, see NYSE and Nasdaq Listing Requirements Compliance and Securities Exchange Compliance Resource Kit.

Other Key Laws and Regulations

There are many key laws and regulations that a securities lawyer working with BDCs should consider. As discussed more fully above, lawyers need to be aware of the various aspects of the 1940 Act and Advisers Act that impose restrictions on BDCs. To ensure compliance with the 1940 Act, legal teams should include a 1940 Act attorney when advising a BDC. There are a number of ongoing 1940 Act

requirements for BDCs. The BDC must include a majority of independent directors, meaning persons who are not interested persons pursuant to Section 2(a)(19) of the 1940 Act. Further, securities must be held by a custodian meeting the requirements of Section 26(a)(1) of the 1940 Act. As mentioned above, there must be a fidelity bond covering officers and employees. The required code of ethics must address investments by officers and directors and transactions among related parties, as well as reporting and recordkeeping. The 1940 Act also imposes restrictions on investments in other investment companies as well as restrictions on percentage interest of the BDC held by an investment fund. In addition, the 1940 Act governs limitations on indemnities, bookkeeping and records requirements, compliance policies and procedures and also calls for the registered investment adviser to have policies and procedures in place.

As mentioned briefly above, BDCs are subject to limitations on related party transactions. BDCs are subject to the limitations of Section 57 of the 1940 Act, which restricts four types of transactions:

- An affiliate may not knowingly sell any securities or other property to the BDC or a company controlled by it, unless the BDC is the issuer, or the affiliate is the issuer, and the security is part of a general offering.
- An affiliate may not knowingly purchase from the BDC or a company controlled by it any security or other property, except securities issued by the BDC.
- An affiliate may not knowingly borrow money or other property from the BDC or a company controlled by it (subject to limited exceptions).
- An affiliate is prohibited from knowingly effecting any joint transactions with the BDC or a company controlled by it in contravention of SEC rules.

Depending on the nature of the proposed transaction, approval will be required either by the majority of the board of directors, including a majority of disinterested members, or exemptive relief from the SEC may be required. Historically, the SEC has granted exemptive relief for both joint investment and joint exits, however, these types of investments are subject to compliance with a number of conditions that are in place to protect investors.

Restricted transactions with the following first tier affiliates of a BDC are prohibited unless the BDC receives prior approval from the SEC:

- Any director, officer or employee of the BDC.
- Any entity that a director, officer or employee of the BDC controls.
- A BDC's investment adviser, promoter, general partner or principal underwriter, or any person that controls or is under common control with such persons or entities or is an officer, director, partner or employee of any such entities.

Restricted transactions with the following second tier affiliates are prohibited unless a majority of the directors or general partners who are not interested persons of the BDC (as defined in the 1940 Act) and who have no financial interest in the transaction approve the transaction:

- Any 5% shareholder of the BDC, any director or executive officer of, or general partner in, a 5% shareholder of the BDC, or any person controlling, controlled by, or under common control with such 5% shareholder.
- Any affiliated person of a director, officer or employee, investment adviser, principal underwriter for or general partner in, or of any person controlling or under common control with, the BDC.

A controlled affiliate is a downstream affiliate of a BDC whose securities are more than 25% owned by the BDC. These controlled affiliates are treated the same as a second tier affiliate when engaging in restricted transactions with the BDC. Lawyers should pay particular attention to this aspect as the affiliated transaction prohibitions of Section 57 flow-through to all controlled affiliates of the BDC. If a BDC owns 30% of one company, that particular company would not be able to purchase securities from a first tier affiliate of the BDC unless the BDC were to get prior SEC approval.

As discussed more fully above, BDCs are subject to the provisions of the 1940 Act with respect to the external manager, if any. Any investment management agreement entered into must be approved by the board initially and annually and must also receive shareholder approval. Further, the investment adviser will also be subject to a conflicts policy and must be registered under the Advisers Act.

There are special tax issues that should be taken into consideration. BDCs are typically organized as limited partnerships in order to obtain pass-through tax treatment. However, a BDC is unable to be a publicly traded partnership under the U.S. federal taxation laws. Therefore, if a BDC is organized as a partnership, its interest cannot be traded on an exchange or it must qualify for one of the exemptions to be treated as a publicly traded partnership for tax purposes. Recently, BDCs have been organized as corporations and obtain pass-through tax treatment by qualifying as regulated investment companies (RICs) under Subchapter M of the Internal Revenue Code of 1986, as amended. To qualify as a RIC, a BDC must, among other things, elect to be treated as a RIC, distribute substantially all (e.g., 90%) of its taxable

income each year and meet certain income and asset diversification tests. At least 90% of a RIC's gross income must be derived from passive sources. At the close of each quarter, a RIC must be adequately diversified, by meeting specified asset diversification tests. When advising BDCs, either in formation or offerings, it is important to include a tax lawyer to address the broad range of tax issues.

A BDC is subject to certain limitations on capital structure. Historically, BDCs were required to maintain an asset coverage ratio of 200%. This means that debt and senior securities could not exceed half of the BDC's total assets. In addition, no dividends could be declared on common stock unless the BDC's debt and senior securities had an asset coverage of 200%. As discussed more fully below, recent legislation has reduced the asset coverage requirement applicable to BDCs from 200% to 150%. This allows BDCs to maintain a 2:1 debt-to-equity leverage ratio.

BDCs may issue common stock as well as more than one class of senior secured debt. In addition, BDCs may issue warrants and options, subject to certain limitations. A BDC must sell shares of its common stock at net asset value. The exception to this is when prior shareholder approval is obtained or when the BDC is engaging in a rights offering. Lawyers may advise BDCs that it may be practical to seek approval from shareholders at the BDCs annual meeting so that the BDC has additional flexibility to raise capital when shares are trading below the NAV.

Regulatory Trends

In March 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 (SBCAA). The SBCAA amended the 1940 Act with respect to several requirements for BDCs. The Small Business Credit Availability Act 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. The reduction can be approved by the BDC in one of two ways. A majority of the BDC's board of directors and a majority of its disinterested directors may approve the decreased asset coverage ratio, however, the effectiveness would be delayed one year following the approval. Alternatively, a majority of the BDC's stockholders may approve the decreased asset coverage ratio, which would become effective upon 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 disclose the BDC's existing leverage ratio and risks associated with increasing the leverage ratio. A BDC the securities of which are 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. For recent BDC trends, see Market Trends 2018/19: Business Development Companies.

Commercial Trends

Beginning in 2010, the number of IPOs consummated by BDCs steadily increased. Recently, however, the number of IPOs has declined. There have only been two major BDC IPOs in the last two years.

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. 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 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 for the BDC. 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.

While the number of IPOs has declined, the private BDC has emerged as a popular alternative for sponsors seeking to access the BDC structure. More than ten private BDCs have been brought to market since 2016. 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 that is typically subject to a shorter review period by the SEC.

On May 30, 2018, the SEC's Division of Investment Management issued an exemptive order that permits private BDCs 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.

BDCs have faced a significant amount of investor activism in recent years. There have been a number of questions raised as to whether management fees and management interests generally align with shareholder interests. There has been an increase in consolidation in the BDC sector recently. This has been driven by the shares of many listed BDCs trading below the NAV, an increased interest in filling gaps in the kinds of assets under management and BDC activism pushing for the maximization of shareholder value. One of the largest acquisitions was when PennantPark Floating Rate Capital Ltd. acquired MCG Capital Corporation.

There also has been an increased interest in joint ventures throughout the BDC sector in recent years. This is primarily driven by the goal to increase portfolio yields. Many BDCs have entered into Senior Loan Fund (SLF) Joint Ventures. SLFs are investment vehicles whereby the BDC and a third party (typically an insurance company or asset manager) commit capital to invest in unitranche and first lien secured loans. Ares Capital Corporation, Capitala Finance Corporation and New Mountain Finance Corporation have all entered into these types of arrangements in recent years. These SLFs have faced scrutiny by some in the sector especially before the reduction in the asset coverage ratio. This is because the implicit leverage in the SLF is not counted towards the BDC's overall asset coverage ratio. For recent BDC trends, see Market Trends 2018/19: Business Development Companies.

Practice Tips

Set forth below is a list of helpful practical tips both for in-house and private practice lawyers:

- In-house lawyers should consider the affiliate transaction constraints of the BDC structure when evaluating the steps involved in a BDC's initial formation transactions.
- In-house lawyers should consider the potential benefits of a private BDC structure in the context of an identified portfolio of assets.
- The external legal team should include 1940 Act lawyers and tax lawyers from the beginning of a BDC transaction, in addition to capital markets lawyers, in order to ensure compliance with all regulations governing BDCs.
- Private practice lawyers should analyze various precedent BDC offerings and structures when forming a new BDC and undergoing a securities offering to ensure that current legal trends and market practices in the BDC sector are followed.

For additional practical tips, see Top 10 Practice Tips: Business Development Companies.

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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.

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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.

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