

## A Year to Remember for Business Development Companies

With 2018 now in the rearview mirror, we summarize below several of the encouraging regulatory developments for business development companies (BDCs) that occurred during 2018:

- On December 19, 2018, the Securities and Exchange Commission (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 Investment Company Act of 1940, as amended (the “1940 Act”) subject to compliance with certain conditions.<sup>1</sup>
- On November 30, 2018, the SEC adopted a new rule establishing a non-exclusive research report safe harbor, Rule 139b, under the Securities Act of 1933, as amended (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.<sup>2</sup>
- On November 14, 2018, the staff of the SEC’s Division of Investment Management 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 of the SEC’s Division of Investment Management 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.<sup>3</sup>
- On September 7, 2018, the staff of the SEC’s Division of Investment Management 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.<sup>4</sup>
- On August 20, 2018, the SEC adopted final disclosure and simplification amendments. The amendments eliminated certain redundant and duplicative disclosure requirements, overlapping disclosure requirements, outdated disclosure requirements, and disclosure requirements

that were inconsistent with recent legislation or generally accepted accounting principles. These amendments became effective in the fall and are applicable to annual reports on Form 10-K for the calendar year ended December 31, 2018.<sup>5</sup>

- On May 30, 2018, the Division of Investment Management of the SEC issued an exemptive order that allows private BDCs to conduct exchange offers pursuant to which BDC investors may elect to exchange their BDC shares for securities in a new split-off extension fund. Given that private BDCs do not have publicly traded shares, this new exchange option provides private BDC investors with a liquidity opportunity following the extension fund's initial public offering.<sup>6</sup>
- The Small Business Credit Availability Act (signed into law on March 23, 2018) 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.<sup>7</sup>
- The Small Business Credit Availability Act also required the SEC to implement amendments to various Securities Act rules and regulations in order to provide parity for BDCs in relation to their corporate peers with respect to securities offerings, offering-related communications, and research safe harbors.<sup>8</sup>
- On March 16, 2018, the SEC's Division of Investment Management 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 nonpublic, confidential review draft registration statements relating to offerings that are submitted by BDCs within one year of an initial public offering.<sup>9</sup>

## Outlook for 2019

While 2018 was productive, additional regulatory reforms for BDCs are expected to be forthcoming in 2019. The securities offering and offering-related communication reforms that were included in the Small Business Credit Availability Act (referenced above) are due to automatically go effective on March 23, 2019 (one year from the Act's adoption) in the event that the SEC does not act sooner to implement the Act's rulemaking mandate. Among other things, these reforms will allow BDCs to qualify as well-known seasoned issuers ("WKSIs") and thereby file automatically effective registration statements which will avoid delays in connection with an SEC review. WKSIs are also able to use free writing prospectuses before the filing of a registration statement and may engage in certain pre-filing communications. BDCs will also be permitted to rely on (i) communication-related safe harbors that are already available to other corporate issuers and (ii) incorporation by reference in their public filings and the ability to file a form of prospectus and final prospectus under Rule 424 of the Securities Act. These changes, once implemented, will provide much needed cost savings to BDCs and efficiency to securities offerings by BDCs without the risk of negatively impacting investors.

Additionally, many BDC industry participants have recommended that the SEC's Division of Investment Management remove or alter the line item titled "Acquired Fund Fees and Expenses" ("AFFE") that is currently required to be included in a BDC's prospectus fee table. AFFE disclosure requires acquiring funds to aggregate and disclose in their prospectuses the amount of total annual acquired fund operating expenses and express the total amount as a percentage of an acquiring fund's net assets. The calculation of AFFE typically results in an overstated expense ratio because an acquiring fund's indirect expenses are often significantly greater than the expense ratio of the BDC. As a consequence, some index providers removed BDCs from their indices, causing a significant

reduction in institutional ownership of BDCs. 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. On December 19, 2018, as part of the release for Rule 12d1-4 described above, the SEC formally requested industry suggestions to improve AFFE disclosure. The BDC market would likely be receptive if the SEC takes action with respect to AFFE disclosure in 2019.

## About Our Business Development Companies Practice

Mayer Brown's leading corporate & securities practice, combined with our knowledge of the 1940 Act, the Advisers Act and the tax considerations applicable to BDCs, make us a regular choice for private equity, investment advisers and other sponsors of BDCs and for the underwriters and placement agents to BDCs.

Learn more about our [BDC practice](#).

In addition, access our [BDC Facts & Stats](#) for a compendium of information regarding the business development companies (BDCs) that have taken measures to increase their use of leverage, the terms of BDC advisory agreements, and more.

## Endnotes

- <sup>1</sup> See our post at <https://goo.gl/skSioU>.
- <sup>2</sup> See our Legal Update at <https://goo.gl/RPLMtg>.
- <sup>3</sup> See our post at <https://goo.gl/PiQM1>.
- <sup>4</sup> See our Legal Update at <https://goo.gl/ii4ncj>.
- <sup>5</sup> See our Legal Update at <https://goo.gl/2bptng>.
- <sup>6</sup> See our post at <https://goo.gl/14BM7z>.
- <sup>7</sup> See our Legal Update at <https://goo.gl/inuD8h>.
- <sup>8</sup> See our summary chart at <https://goo.gl/hi15Cm>.
- <sup>9</sup> See our post at <https://goo.gl/f4w1SU>.

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