A Primer On Private Business Development Companies
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Financial sponsors and investors are seeking alternative investment products through which they can access the capital markets. The private business development company, or BDC, is one such alternative investment product that has recently been successful at capital raising.

Private BDCs generally hold originated debt portfolios and generate stable cash flows from regularly paid dividends without being subject to market volatility. As such, private BDCs are popular alternative investment products for large private equity platforms with lending arms. For example, TPG Specialty Lending Inc.,[1] the first BDC to operate as a private BDC, is advised by an affiliate of TPG Global LLC, a global private investment firm with approximately $82 billion of assets under management as of Dec. 31, 2017, and TCG BDC Inc., the only BDC to conduct an initial public offering since 2016, is advised by an affiliate of The Carlyle Group LP, a global alternative asset manager with approximately $195 billion of assets under management as of Dec. 31, 2017.

Since 2016, 13 of the 16 BDCs that have been formed, commenced operations as private BDCs. As of March 11, 2018, there were 94 operating BDCs with aggregate assets of approximately $97 billion. Of these BDCs, 23 were operating as private BDCs with aggregate assets of approximately $13 billion.

What Is a BDC and What Is a Private BDC?

A BDC is a closed-end investment company that has filed an election to be treated as a BDC pursuant to the Investment Company Act of 1940. Upon electing to be treated as a BDC, the BDC is required to comply with certain provisions of the 1940 Act (the “BDC provisions”). The BDC provisions require that at least 70 percent of the BDC’s investments be in certain eligible portfolio companies and that the BDC comply with certain operational provisions of the 1940 Act. In addition, the BDC provisions require that the BDC make significant managerial assistance available to its eligible portfolio companies, maintain an asset coverage ratio of at least 200 percent (which may be reduced to 150 percent in certain circumstances), not issue shares below its net asset value per share without shareholder approval, and comply with limitations relating to its ability to enter into transactions with affiliates.
Generally, BDCs are either listed, nonlisted or private. Both listed and nonlisted BDCs offer securities in transactions that are registered under the Securities Act of 1933; however, listed BDCs list their securities on a national securities exchange and nonlisted BDCs do not. Private BDCs do not list their securities on a national securities exchange and only offer their securities in transactions that are exempt from the registration requirements of the 1933 Act.

**How Is a Private BDC Formed?**

The basic steps to form a private BDC are:

- First, form the entity, which is generally a Delaware or Maryland corporation.
- Then, file a registration statement on Form 10 to register a class of securities under the Securities Exchange Act of 1934.
- Finally, elect to be regulated as a BDC by filing Form N-54A.

The private BDC must also hold an organizational meeting of its board of directors to accomplish basic corporate housekeeping matters, including authorizing banking and appointing officers. In addition, the private BDC's board of directors must authorize the entry into certain material contracts including, most often, an investment advisory agreement. It is important to note that investment advisory agreements must be approved by a majority of the private BDC’s board of directors, including a majority of the independent directors, and that such approval must be at an in-person meeting of the board of directors.

**How Is a Private BDC Offered?**

Private BDCs offer their shares to accredited investors in private placements that are exempt from the registration requirements of the 1933 Act pursuant to Section 4(a)(2) and Regulation D of the 1933 Act. Private BDC private placements are most frequently structured using a capital call model similar to that used by private equity funds. Private BDCs are often seen as a hybrid between traditional registered funds and private equity funds because, like a registered fund, they make filings required by the 1934 Act and, like a private equity fund, they are offered through a private placement/capital call process.

Placement activities for a private BDC's offering may be conducted by officers of the BDC or its investment adviser. Private BDCs are often sponsored by large private equity firms that are well-suited to conduct placement activities because they have existing relationships with accredited investors who are familiar with the capital call model. In addition, the private BDC or the investment adviser may engage a placement agent to assist with the solicitation of investors.

In a capital call model, each investor makes a capital commitment to the private BDC. The private BDC enters into a subscription agreement with each investor pursuant to which the investor is obligated to purchase shares of the private BDC, up to the amount of the investor’s capital commitment, within a certain period of time following the investor’s receipt of a drawdown notice. The shares are purchased at a price equal to a recent net asset value per share of the private BDC.
How Does a Private BDC Offer Liquidity?

Because the private BDC’s shares are not registered under the 1933 Act or listed on an exchange, the shares can only be transferred to other accredited investors and such transfers generally require the consent of the private BDC’s investment adviser. To afford their shareholders some future liquidity, the private BDC’s subscription agreements and operative documents often provide that the private BDC will be wound down if a liquidity event has not occurred by a certain date in the future. Liquidity events may include:

- An exchange listing that may be structured as a direct listing or made in connection with a registered public offering. The private BDC’s board of directors must approve any exchange listing.
- A merger whereby the private BDC merges into an existing traded BDC. Both BDCs’ boards of directors and shareholders would generally be required to approve a merger.
- A spinoff whereby the private BDC contributes assets to a new, traded BDC and shares of the traded BDC are distributed to the private BDC’s shareholders. Both BDCs’ boards of directors and shareholders would generally be required to approve a spinoff and the spinoff would require exemptive relief from the SEC.[2]

How Is a Private BDC Operated?

All BDCs, including private BDCs, invest and structure their portfolios in the same manner and must comply with the 1934 Act and the BDC provisions of the 1940 Act. Consequently, private BDCs must file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K as well as proxy statements. In addition, the private BDC’s shareholders with beneficial ownership in excess of 5 percent must file Schedule 13D or 13G in accordance with Section 13 of the 1934 Act, and the private BDC’s officers and directors and shareholders with beneficial ownership in excess of 10 percent must file Forms 3, 4 and 5 in accordance with Section 16 of the 1934 Act.

Why Is the Private BDC Structure Desirable?

The primary advantages of the private BDC structure are optionality and efficiency.

The capital call process allows management the optionality to call funds as investment opportunities arise. In addition, management may, with appropriate approvals, determine the timing and structure of liquidity events in the future, based on market conditions at the time.

The process to launch a private BDC is also potentially shorter than that to launch a traded or nontraded BDC, and there is no need to list the private BDC’s shares on an exchange or to complete the “blue sky” registration process applicable to nontraded BDCs conducting a continuous offering. The private placement process may be less costly because it does not involve underwriters, a roadshow or the blue sky process. In addition, the private BDC structure is also generally attractive to foreign investors and does not need to be formed with separate investment vehicles for on-shore and off-shore investors.

Together, this optionality allows management to quickly and efficiently launch a private BDC regardless of market conditions. Management can then solicit capital commitments and draw capital at a pace that
is in sync with its investment pace and, with relevant approvals, determine in the future the liquidity event that would be most beneficial to the private BDC’s shareholders based on conditions at that time.[3]

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[1] TPG Specialty Lending Inc. completed its initial public offering on March 21, 2014, and currently trades on the New York Stock Exchange under the symbol “TSLX.”

[2] On May 9, 2018, a notice (Investment Company Act Release No. 33094; File No. 812-14765 TCW Direct Lending LLC et al.) was issued with respect to TCW Direct Lending LLC’s application for exemptive relief in connection with its proposed spinoff transaction. If the relief requested by TCW is granted, TCW will be the first private BDC to receive relief for a spinoff transaction.

[3] For additional information on private BDCs including a webcast and a videocast on the topic, please visit www.publiclytradedprivateequity.com/multimedia.