Shedding New Light on Business Development Companies

by Steven B. Boehm, Cynthia M. Krus, Harry S. Pangas and Lisa A. Morgan

In the 1970s, a perceived crisis in the capital markets led Congress to enact the Small Business Investment Incentive Act of 1980 (1980 Amendments). The genesis of the crisis stemmed from the limitation set forth in the “small private investment company” exemption contained in Section 3(c)(1) of the Investment Company Act of 1940 (1940 Act). In essence, private equity and venture capital firms believed that their capacity to provide financing to small, growing business was being stymied by their inability to raise equity capital due to the limitation in Section 3(c)(1) that their securities not be beneficially owned by more than 100 persons. Because these firms were unwilling to subject themselves to the 1940 Act, they urged Congress to ameliorate the situation before the spigot of capital to small, growing businesses was closed shut. Congress responded to such concerns by enacting the 1980 Amendments.

The 1980 Amendments amended the 1940 Act and the Investment Advisers Act of 1940 (the Advisers Act) to add a new category of closed-end investment company known as a business development company (BDC). BDCs are publicly traded closed-end funds that make investments in private or thinly-traded public companies in the form of long-term debt or equity capital, with the goal of generating capital appreciation and/or current income. Specifically, the 1980 Amendments were designed to encourage the establishment of public vehicles that invest in private equity in order to increase the flow of capital to small, growing businesses. The 1980 Amendments sought to achieve this goal by lessening some of the restrictions under the 1940 Act that were believed to discourage private equity managers from participating in the regulated portion of the investment management industry, most notably restrictions relating to compensation and borrowing.

Congress believed that BDCs would become a
widely used investment vehicle from the outset. However, the anticipated popularity of BDCs did not catch on quite as quickly as anticipated by the proponents of the 1980 Amendments. Although there are approximately 30 active BDCs that manage in excess of $9.5 billion of assets, until very recently, these vehicles operated in relative anonymity, barely scratching the surface of the financial press and were generally the subject of less regulatory guidance than larger, more financially significant industries, such as the mutual fund industry, by the Securities and Exchange Commission (SEC).

Recently, the BDC industry has been thrust into the limelight. A spate of more than 10 filings for initial public offerings (IPOs) by would-be BDCs sponsored by high-profile private money managers, followed by a highly magnified level of SEC regulatory scrutiny likely spurred on by intense negative media coverage of these BDCs, has brought a fundamental change to the landscape. Notwithstanding such change, it remains to be seen whether BDCs will gain widespread acceptance by the marketplace.

Regulatory Structure

When Congress adopted the 1980 Amendments, it made the provisions of the 1980 Amendments immediately effective. As a result, the staff of the SEC’s Division of Investment Management (Staff) had to scramble to revise the SEC’s rules and forms to accommodate BDCs. Many of the changes made to these rules and forms have never been revisited by the SEC or the Staff. Thus, counsel advising promoters of BDCs have to use care to ensure that their clients are aware of the unique attributes of the BDC regulatory structure.

The BDC regulatory structure can best be described as a patchwork of rules woven into the fabric of the 1940 Act. The 1980 Amendments provide a general exemption for BDCs from the provisions of the 1940 Act and make them subject to Sections 54 through 65 of the 1940 Act, which were added specifically to regulate BDCs (BDC Sections). Notwithstanding the general exemption for BDCs from the 1940 Act, Section 59 of the 1940 Act provides that “Sections 1, 2, 3, 4, 5, 6, 9, 10(f), 15(a), (c), and (f), 16(b), 17(f) through (j), 19(a), 20(b), 32(a) and (c), 33 through 47, and 49 through 53 of this title shall apply to a business development company to the same extent as if it were a registered closed-end investment company.”

BDCs are not “registered” investment companies, but instead are closed-end investment companies that “elect” to be treated as a BDC under the 1940 Act by filing a notice to that effect with the SEC. As a prerequisite to making a BDC election, a company must have a class of its equity securities registered under the Securities Exchange Act of 1934 (the 1934 Act). As a result, BDCs must file periodic and current reports (i.e., Forms 10-Q, 10-K and 8-K) as well as proxy statements with the SEC pursuant to the 1934 Act like those filed by public operating companies. Therefore, a BDC can best be thought of as a hybrid between a closed-end fund and an operating company.

BDCs may be operated as internally managed investment companies or externally managed investment companies. To date, the internally managed structure has predominated. An internally managed BDC does not have an investment adviser and is managed by its executive officers under the supervision of its board of directors. As a result, an internally managed BDC does not pay investment advisory fees, but instead pays the operating costs associated with employing investment management professionals.

BDCs issue a fixed number of shares to the public through public offerings, after which the shares are bought and sold on a national securities exchange or association. BDCs are not obligated to issue new shares or redeem outstanding shares as open-end funds are required to do. The price of a share in a BDC is determined entirely by market demand, so shares can either trade below their net asset value (at a discount) or above it (at a premium). BDCs use equity capital raised through public offerings and debt capital from various sources to make their investments.

Portfolio Investments

Consistent with the Congressional purpose behind the 1980 Amendments (i.e., increasing the flow of capital to small, growing businesses), a BDC is, in effect, required by Section 55(a) of the 1940 Act, to have at least 70 percent of its investments in eligible assets. Eligible assets, for purposes of Section 55(a) of the 1940 Act, include, among other things:

- Securities of an “eligible portfolio company” that are purchased in a private transaction from that company, an affiliated person of such company, or from any other person,
- Securities received by the BDC in connection with its ownership of securities of an “eligible portfolio company,” or
- Cash, cash items, government securities, or high quality debt securities maturing one year or less from the time of investment.

As a practical matter, “eligible portfolio compa-
percent of the BDC’s outstanding shares, then the as a component of their compensation, represents 15

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 opportunities.

Significant managerial assistance refers to any

arrangement whereby a BDC provides significant

guidance and counsel concerning the management,

operations, or business objectives and policies of a

portfolio company. Examples of such activities

include arranging financing, managing relationships

with financing sources, recruiting management per-

sonnel, and evaluating acquisition and divestiture

opportunities.

Regulation of Compensation

The 1980 Amendments reflect Congress’ recogni-
tion of the common practice in the private equity

world of issuing derivative securities to management

and other employees. Consequently, unlike other

investment companies, BDCs are able to issue

options, warrants, and rights that convert to voting

securities to its officers, employees and directors.

Any issuance of derivative securities requires the

approval of the BDC’s board of directors and author-

ization by the BDC’s shareholders. The BDC also

may not issue derivative securities to its nonemploy-

ee directors unless it first obtains an exemptive order

from the SEC.

In general, the amount of voting securities that

would result from the exercise of all derivative secu-

rities of a BDC at the time of issuance is not permit-
ted to exceed 25 percent of the outstanding voting

securities of the BDC. However, if the outstanding
derivative securities issued to management personnel

as a component of their compensation, represents 15

percent of the BDC’s outstanding shares, then the

total amount of derivative securities that the BDC

may issue, as a percentage of its total outstanding

shares, is 20 percent.

A BDC may operate a profit-sharing plan for its

employees, subject to certain restrictions. A BDC

cannot, however, maintain such a plan if it maintains

a stock option plan for management, or is externally

managed by a registered investment adviser.

In the case of externally managed BDCs, Section

205(b)(3) of the Advisers Act permits external invest-

ment managers to BDCs to receive incentive fees

(also known as performance fees) akin to those

charged in the private equity fund world if the BDCs
do not have outstanding any equity-based compensa-
tion arrangement or profit-sharing plan. Specifically,

Section 205(b)(3) provides an exception from the
general prohibition on an investment adviser charg-
ing an incentive fee based on a share of capital gains.
Thus, the investment adviser to an externally man-

aged BDC may assess an incentive fee of up to 20

percent on a BDC’s realized capital gains net of all

realized capital losses and unrealized capital depreci-

ation over a specified period.6

Operational Considerations

As with any other company subject to the 1940

Act, a BDC must adhere to certain substantive regu-

latory requirements with respect to its operations,

including the following:

Composition of Board of Directors. In accordance

with Section 56(a) of the 1940 Act, a majority of the

directors of a BDC must be persons who are not

“interested persons” of the BDC as defined in

Section 2(a)(19) of the 1940 Act. In addition, under

new SEC rules, any BDC that intends to rely on cer-

tain designated exemptive rules under the 1940 Act

will be required to have a minimum of 75 percent of

the board be directors who are not “interested per-

sons” of the BDC.7

Indemnification. A BDC is prohibited from pro-

tecting any director or officer against any liability to

the BDC, or its security holders, arising from willful

misfeasance, bad faith, gross negligence or reckless

disregard of the duties involved in the conduct of

such person’s office. This prohibition also applies to

any external investment adviser of a BDC.

Transactions with Related Persons. Transactions

involving a BDC and certain affiliated persons of the

BDC, including officers, directors, employees, mem-

bers of an advisory board, the investment adviser, the

principal underwriter, and persons controlling or

under common control with the BDC, are generally

prohibited, absent an SEC exemptive order.

Transactions involving a BDC and companies that it
controls (i.e., those in which it owns more than 25 percent of the voting securities) generally are not subject to this limitation.

**Code of Ethics.** A BDC (and its investment adviser) must adopt a code of ethics that establishes procedures regarding personal investments by the BDC’s officers and directors, and restricts certain transactions between such officers and directors on the one hand and the BDC on the other hand.

**Fidelity Bond.** A BDC must maintain a bond issued by a reputable fidelity insurance company to protect the BDC against larceny and embezzlement.

**Compliance Programs.** New Rule 38a-1 of the 1940 Act requires a BDC to:

- Adopt and implement policies and procedures designed to prevent violation of the federal securities laws;
- Review these policies and procedures annually for their adequacy and the effectiveness of their implementation; and
- Appoint a chief compliance officer to administer the compliance policies and procedures.

In addition, new Rule 206(4)-7 under the Advisers Act requires an investment adviser of a BDC to adopt and implement policies and procedures reasonably designed to prevent violation of the Advisers Act, and the rules the SEC has adopted thereunder, by the investment adviser or any of its supervised persons.

Because BDCs are required to register a class of equity securities under the 1934 Act, the requirements imposed on public operating companies pursuant to the Sarbanes-Oxley Act of 2002 generally apply to BDCs. For example:

- The chief executive officer and chief financial officer of a BDC must certify the accuracy of the financial statements contained in the BDC’s periodic reports;
- A BDC’s periodic reports must disclose management’s conclusions about the effectiveness of the BDC’s disclosure controls and procedures; and
- A BDC may not make any loan to any director or executive officer or materially modify any existing loans.

In addition, BDCs that have their securities listed or traded on the New York Stock Exchange (NYSE), the Nasdaq Stock Market, Inc. (Nasdaq) or the American Stock Exchange (AMEX) must comply with the corporate governance listing standards of the relevant exchange or association. Some of the more significant corporate governance listing standards of the NYSE, Nasdaq and AMEX that BDCs have to comply with include:

- A listed BDC must have an audit committee composed solely of “independent directors” (as defined by the applicable exchange or association);
- The director nominees of a listed BDC must be identified by the BDC’s independent directors;
- The compensation of a BDC’s executive officers must be subject to the oversight of the BDC’s “independent directors;”
- The non-management or independent directors of the BDC must hold regularly scheduled executive sessions; and
- The BDC must adopt a code of business conduct and ethics.

Finally, as noted, any BDC that intends to rely on certain designated exemptive rules under the 1940 Act will be required to comply with the “fund governance standards” set forth in new Rule 0-1(a)(7) of the 1940 Act. In particular, new Rule 0-1(a)(7) of the 1940 Act will require that (1) at least 75 percent of the directors of the BDC must be persons who are not “interested persons” of the BDC, (2) the chairman of the board of the BDC must be an independent director (i.e., a director who is not an “interested person” of the BDC), (3) the board of the BDC must perform a self-assessment at least once annually, (4) the independent directors of the BDC must meet separately at least once a quarter, and (5) the independent directors of the BDC must be affirmatively authorized to hire their own staff. The compliance date for new Rule 0-1(a)(7) of the 1940 Act is January 16, 2006.

**Tax Status.** A BDC may elect to be taxed either as a “C corporation” (like typical operating companies) or as a “regulated investment company” (RIC) under Subchapter M of the Internal Revenue Code of 1986. As a RIC, a BDC can avoid taxation at the company level on that portion of income and capital gains distributed to shareholders. To qualify for RIC treatment, in general at least 90 percent of the BDC’s income must consist of interest, dividends, gains from sales of securities and similar types of income and gains, and the BDC must distribute to its shareholders for each taxable year at least 90 percent of its investment company taxable income (consisting generally of net investment income from interest and dividends and net short-term capital gains). The RIC provisions also require a BDC to comply with certain requirements with respect to its portfolio diversification, including that not more than 25 percent of the value of its assets be invested in the securities of one
issuer or of two or more issuers that are controlled by the BDC.

**Dominance of Internally Managed BDCs**

Prior to the recent wave of BDC IPO filings, the BDC space was dominated by a small number of internally managed BDCs. These BDCs generally relied on a management team devoted solely to operating the BDC’s business (i.e., they managed no other funds) and relied on stock option plans or profit-sharing arrangements in order to provide incentives to members of their senior management. These BDCs were generally of three types: (1) growth focused; (2) value focused; and (3) income-producing. The following illustrates the three types of BDCs, and the focus of their investing activity:

1. **Growth-Focused**—Growth-focused BDCs resemble pure venture capital enterprises that seek high returns on investment by investing in early development stage companies primarily through equity instruments. Their portfolio companies typically have a limited operating history and consequently investments in them involve a significant degree of speculation. However, the potential gains they offer are regarded as outweighing their inherent risks.

2. **Value-Focused**—Value-focused BDCs seek to achieve more moderate returns on investment than growth-focused BDCs by investing in companies with more established operations, which consequently entails less speculation.

3. **Income Producing**—Income-producing BDCs seek high current income and capital gains by making loans to later-stage companies with significant cash flow. As an added incentive to provide financing, income-producing BDCs generally receive warrants from their portfolio companies, which provide the BDC with potential for capital gains.

Historically, the larger BDCs have focused their investment activity on producing current income, which has enabled them to generate a stream of interest or dividend income from their investments and permitted them to pay dividends to their stockholders. Unlike registered closed-end funds, the stock of these BDCs have frequently traded at premiums to their net asset values.

In light of the success of internally managed, income-producing BDCs, they were viewed as the gold standard. Allied Capital Corporation (Allied Capital), one of the nation’s first BDCs and a publicly-traded lender to small businesses since 1960, was often held up as the model. With a market capitalization of approximately $3 billion, it remains the nation’s largest BDC and, having paid dividends quarterly for the past 40 years, one of the most widely followed by analysts. The success of Allied Capital, particularly following the 1997 announcement of its conversion from an externally managed BDC to an internally managed BDC, lead to IPOs by other internally managed BDCs. American Capital Strategies Ltd. (ACAS), MCG Capital Corporation, and Gladstone Capital Corporation (GCC), effected successful IPOs between late 1997 and 2001, with ACAS and GCC going public as blind pools.

However, in April 2000, the most ambitious effort to launch an externally managed BDC was reflected in the $330 million IPO by MeVC Draper Fisher Jurvetson Fund I, Inc. (MeVC), which sought to capitalize on the booming technology sector. The timing of the offering was imperfect, however, as the April 2000 IPO coincided with the collapse of the technology bubble. As a consequence of its market performance, MeVC failed to ignite an interest in externally managed BDCs.

In view of the foregoing, it seemed to be generally accepted that externally managed BDCs were not a viable alternative in the marketplace. This view was reinforced by high-profile shareholder lawsuits filed against two externally managed BDCs, MeVC and Brantley Capital Corporation, relating to lackluster investment performance. In late 2003, however, that would drastically change.

**New Wave of Externally Managed BDCs**

In the fall of 2003, Technology Investment Capital Corporation (TICC), structured as an externally managed BDC, successfully completed a $130 million blind pool IPO of shares of its common stock. TICC compensated its external investment adviser with an incentive fee structure that had not been seen before in the BDC space. TICC’s external adviser would receive a base management fee of 2 percent, and an incentive fee of 20 percent on TICC’s capital gains, as calculated under Section 205(b)(3) of the Advisers Act, as well as 20% of TICC’s pre-incentive fee net investment income. At the time TICC’s IPO was completed, its investment adviser became one of a handful of advisers of BDCs to assess an incentive fee pursuant to Section 205(b)(3) of the Advisers Act, and the first to receive an incentive fee based on investment income received by the BDC.

The success of TICC’s IPO had a dramatic impact on the financial markets’ perception of the viability of an externally managed BDC. In April 2004, an affili-
Incentive fees charged by the external investment manager of Apollo Capital Management, L.P., one of the nation’s best known private equity firms, launched its own externally managed BDC, Apollo Investment Corporation (Apollo), through a $930 million IPO. Apollo’s incentive fee structure was substantially similar to TICC’s incentive fee structure.

Following the lead of Apollo Capital Management, L.P., around 10 other private equity firms filed registration statements to take new BDCs public. All of these proposed BDCs were externally managed and had an incentive fee structure substantially similar to the TICC/Apollo model. Based on the aggregate offering price of the proposed IPOs, if all of these offerings had been successfully completed, the size of the BDC industry would have doubled overnight. The roster of sponsors of these new funds read like a who’s who of Wall Street, and included Kohlberg Kravis Roberts & Co., the Blackstone Group Holdings L.P., and Thomas H. Lee Partners, L.P., among other prominent fund managers.

The allure of the BDC structure to private equity managers is not difficult to understand. The public vehicle format can provide both a lower cost of capital than that which is available through private equity raises and a permanent source of capital (as opposed to the standard periodic capital return requirements in the private equity world). The ability of Apollo to raise close to $1 billion within less than two months from the date it filed its registration statement with the SEC also provided a tremendous incentive for private equity firms to form BDCs. Typically, the managers of private equity firms have to travel extensively meeting, soliciting and negotiating with institutional investors in order to form a private equity fund. This is both a long and arduous process for the private equity managers. The BDC model appeared to effectively provide private equity managers with access to the much larger public investor base as well as allow them to avoid this long process.

Because of the number of marquee fund managers seeking to IPO an externally managed BDC, the financial press immediately became fascinated with this new IPO craze. Some articles highlighted the positive aspects associated with these new BDCs, such as the needed liquidity these BDCs would bring to small and middle market companies. However, many articles tended to criticize the new BDCs. In particular, the critics tended to focus on the fact that: (1) the new offerings were essentially blind pools with no assets or operations and thus difficult for investors to adequately evaluate; (2) the companies had no existing operations on which the market could reasonably place some type of premium; (3) the incentive fees charged by the external investment adviser to these new BDCs were “aggressive” or “excessive;” and (4) the shares of the new BDCs would almost always trade at a discount to the IPO price as a result of the underwriting discounts and commissions associated with them. Managers wishing to form a BDC would be well advised to take note of the criticism being leveled against the new BDCs and develop ways to short-circuit such criticism in connection with their proposed BDC IPOs.

**Building an Investment Portfolio**

As critics have suggested, one of the areas of greatest concern for new BDCs is how to efficiently build a portfolio of investments that will generate current income to pay dividends to stockholders. The period of time that it takes to ramp-up investments will be critical to the financial markets’ reception of a new BDC. This is especially the case for externally managed BDCs due to the fact that their investment advisers will receive a base management fee on any cash held by the BDCs.

The “blind pool” aspect of these new BDCs may be addressed by providing investors with as much detail as possible about the BDC’s investment objective and strategies for building the investment portfolio. An extensive investment track record of the manager of the BDC may be useful in allaying investor fears to some degree. Several newly public BDCs, including TICC and Prospect Energy Corporation (Prospect Energy), entered into non-binding agreements with prospective portfolio companies to make investments in them during the pendency of their IPOs in order to give investors a sampling of the nature of their prospective investment portfolios. Other proposed BDCs have attempted to tackle the criticism surrounding the receipt of a 2 percent base management fee during the period before the BDCs have invested a significant amount of the cash they raised in the IPO by voluntarily agreeing to reduce their base management fees until the portfolio has been substantially invested. Alternatively, a promoter of a BDC can convert an existing investment portfolio into a BDC to eliminate any concerns regarding the “blind pool” feature associated with these new BDCs.

Managers of BDCs must also be cognizant of the limitations imposed on the types of investments that BDCs may make when planning their strategies for building their investment portfolios. In this regard, at least 70 percent of a BDC’s assets must be “qualifying assets,” which generally includes securities of an “eligible portfolio company” (i.e., private or thinly traded public companies), cash, cash equivalents, US government securities or high-quality debt securities.
maturing in one year or less. Historically, it was the view of the industry that a BDC had complete discretion to hold up to 30 percent of its assets in any type of investment. By its terms, the BDC Sections specify no limitations in that regard, and it appears that the issue had not previously been raised by the Staff, either in connection with their routine examinations of BDCs or in connection with their review of public filings by BDCs. However, beginning with the new BDC filings, the Staff took the position that there was some level of constraint on a BDC’s freedom of investment with respect to all of its assets. Basically, in support of its position, the Staff pointed to language in the BDC Sections that defines a BDC as any closed-end company which is operated “for the purpose of making investments in [the securities of private or thinly traded public US companies].”

To date, no formal guidance has come from the SEC or the Staff on this issue. However, it appears that there is no specific limitation on the ability of a BDC to invest in any particular type of security that does not fall within the 70 percent basket (e.g., securities of foreign issuers, large cap public companies, or investment funds). However, for each type of investment which does not qualify for inclusion in the 70 percent basket, the BDC should be prepared to explain to the SEC how that investment is consistent with the “purpose” of the BDC as set forth in the BDC Sections. As a practical matter, there appears to be some flexibility in satisfying this standard. Thus, for example, the need for liquidity, investment in a private fund which pursues investment strategies similar to those pursued by the BDC, or investment in a public company whose success may be stimulated or revived by the infusion of new capital or managerial assistance would satisfy this standard.

Managers of BDCs will also have to keep an eye on where the Staff ends up on the marginability issue that it raised in connection with its review of the new BDCs. In this regard, Section 2(a)(46)(C)(i) of the 1940 Act states that “[a]n eligible portfolio company is generally a domestic company that . . . does not have a class of securities . . . with respect to which a broker may extend credit . . . pursuant to rules or regulations adopted by the [Federal Reserve].” [Emphasis added.] Specifically, the Staff inquired as to the impact on the types of securities that BDCs may appropriately classify as securities of an “eligible portfolio company” as a result of the changes in the rules of the Federal Reserve regarding the extension and maintenance of margin credit. The Staff was focusing on a 1998 change to the Federal Reserve’s margin rules that effectively made any debt security issued by any entity as a marginable security. The inference of a literal application of the margin rules creates uncertainty for BDCs.

Congress could not have foreseen that the changes in the Federal Reserve’s marginability standard would effectively limit a BDC’s ability to invest in a private company with outstanding debt securities. Congress created BDCs to stimulate financing in private companies which were “unable to borrow money through conventional sources or which do not have ready access to the public capital markets because of their size, seasoning or financial condition” [emphasis added]. As a result, we believe that any interpretation of the marginability standard should further the purpose for which Congress created BDCs. Moreover, if the marginability standard is no longer a useful measure for determining whether a company is the type of company that Congress sought to provide financing to through the creation of BDCs, then Congress or the SEC should adopt an alternative standard.

The impact of this issue may be rendered moot by a legislative proposal whose genesis predated the recent BDC filing frenzy and that has been winding its way through Congress. The legislation would eliminate the marginability standard and clarify that all private US companies, irrespective of whether they have outstanding debt securities, are “eligible portfolio companies.” In addition, this legislation would add a new “eligible portfolio company” standard based on criteria relating to the market capitalization of public companies. Specifically, a public company with a market capitalization of $250 million or less would be deemed to be an “eligible portfolio company.” Thus, BDCs would be able to provide financing to cash-strapped companies that went public during a bull market but have no access to public capital during a bear market. Both of these changes are consistent with the purpose and intent of using the marginability standard in the 1980 Amendments as a barometer of determining whether a company is “unable to borrow money through conventional sources or . . . do[es] not have ready access to the public capital markets because of [its] size, seasoning or financial condition.” Furthermore, the elimination of the marginability standard is simply an acknowledgement that it no longer identifies the category of companies that Congress intended BDCs to finance.

**Investment Adviser Compensation**

As Congress understood, a critical issue for enticing private equity managers to form a BDC was allowing them to be compensated in a manner similar to
which they are compensated for managing a private equity fund. Congress addressed this issue by adding Section 205(b)(3) to the Advisers Act in order to permit investment advisers to BDCs to receive capital gains incentive fees akin to those charged in the private equity fund world. Nevertheless, the negative press reaction to the incentive fees to be received by the investment advisers to the new BDCs has increased the Staff’s scrutiny of these incentive fees.

Notwithstanding such increased regulatory scrutiny, neither the SEC nor the Staff has issued any formal guidance on how BDCs should calculate the capital gains incentive fee permitted by Section 205(b)(3) of the Advisers Act. Moreover, the provision is silent as to the calculus to be applied to the measurement of unrealized capital depreciation with respect to a particular measuring period. Thus, for example, Section 205(b)(3) of the Advisers Act makes no reference to whether the unrealized capital depreciation by which the fee must be reduced includes only depreciation below the original cost of the security in question, or whether it includes a decrease in value in a security above the original cost but below the point of a previous unrealized capital appreciation.

Although the Staff has taken no formal position on this issue, or other aspects of the calculation of the capital gains incentive fee, it has required that these new BDCs include extensive disclosure in their registration statements to illustrate how the incentive fees would be calculated under varying scenarios. In addition, many of the proposed BDCs modified their incentive fee structures during the registration statement process. Although these changes appear to be more market driven than regulatory driven, counsel advising potential promoters of externally managed BDCs should give careful consideration to where the Staff ultimately comes out on how the incentive fee must be calculated.

Although the Staff also raised some early questions with respect to the use of an incentive fee against income, that issue appears to have been dismissed. The Advisers Act contains no prohibition against an adviser taking an incentive fee against income. This contrasts with incentive fees from capital gains, which are expressly prohibited unless assessed pursuant to an exception like that provided in Section 205(b)(3) of the Advisers Act.

Looking Ahead

Two of the new BDCs, Prospect Energy and Ares Capital Corporation, successfully completed their IPOs and raised an aggregate of $270 million since Apollo’s IPO. Although these offerings were reduced from their initial filings, these BDCs were still able to access the market notwithstanding the fact that several new BDCs withdrew their registration statements “due to market conditions.” In addition, existing BDCs have raised almost $1 billion so far this year. Thus, there still appears to be an appetite for BDC offerings despite the dampening of some of the early ardor of underwriters, issuers and investors for the new BDCs.

It is difficult to generalize as to why private equity managers decided to make a foray into the regulated BDC environment in early 2004, but what is clear is that private equity managers are likely to continue to seek to access the BDC model in the future. It appears that a number of private equity managers believe that the advantages of the BDC structure over the private equity model (e.g., access to public equity capital) remain compelling and, as a result, the formation of a BDC continues to merit serious consideration. However, the pace at which this recent BDC trend continues will largely depend upon the performance of the new BDCs.

It is also worth highlighting that the recent flurry of IPO filings by proposed BDCs has vindicated the Congressional purpose behind the creation of BDCs—to stimulate financing to small companies neglected by traditional financing sources. In this regard, it has been well documented that over the last several years the market for lending to small and middle market companies has been underserved by traditional financing sources. BDCs will continue to play this important “gap-filling” role going forward.

Finally, it should be very interesting to see how these private equity managers who recently have chosen to operate through a BDC acclimate themselves to a regulated environment and the uncertainty that sometimes arises in such an environment. With the recent focus on BDCs, a proactive stance by the SEC and the Staff will go a long way in reducing some of the uncertainty inherent in the regulatory environment.

Notes

1. See Reginald L. Thomas and Paul F. Roye, “Regulation of Business Development Companies under the Investment Company Act,” Southern California Law Review at Vol. 52 (1982) (“Section 3(c)(1) posed a problem for [private equity and venture capital firms] as they expanded and eliminated sources of potential funds. Many [private equity and venture capital firms] felt that the [1940] Act’s requirements were too burdensome and, to avoid them, either went out of business or limited their growth.”)

3. See H.R. Rep No. 96-1341, at 65 (1980). The legislative history of the 1980 Amendments notes that “. . . approximately 20 to 30 firms may likely register as BDCs within the first year after the date of enactment . . . [I]t is estimated that approximately 2 to 5 professional staff . . . would be required to review the net additional increases in requests for registration and interpretations.” Id.

4. “As of August 1981, seven companies had elected to be regulated as business development companies and two companies had issued securities to the public since the adoption of the [1980 Amendments].” See Thomas and Roye, supra n.4.

5. For example, the SEC initially intended to create a new registration statement to be used by BDCs to register their securities under the Securities Act of 1933. Instead, the SEC revised the registration statement used by registered closed-end investment companies to permit its use by BDCs. In doing so, the SEC neglected to afford BDCs the same privileges as other companies subject to the Securities Exchange Act of 1934, namely the ability to incorporate their Securities Exchange Act of 1934 reports by reference into their registration statements. See SEC Release No. 11703 (March 26, 1981) (“Congress also expressed the intent that the Commission adopt new registration forms and adapt existing ones for business development companies on an expedited basis. The Commission is not adopting new registration statement forms for business development companies currently, however, because additional experience with the operations of such companies appears necessary before new forms are developed.”)

6. See Section 205(b)(3) of the Advisers Act. Section 205(b)(3) provides that “Section 205(a)(3) shall not apply with respect to any investment advisory contract between an investment adviser and a business development company, as defined in this title, if: (A) the compensation provided for in such contract does not exceed 20 per centum of the realized capital gains upon the funds of the business development company over a specified period or as of definite dates, computed net of all realized capital losses and unrealized capital depreciation, and the condition of Section 61(a)(3)(B)(iii) of 1940 Act is satisfied, and (B) the business development company does not have outstanding any option, warrant or right issued pursuant to Section 61(a)(3)(B) of the 1940 Act and does not have a profit-sharing plan described in Section 57(n) of the 1940 Act.”


8. Subsequent to its IPO, MeVC changed its name to MVC Capital, Inc.


10. See Section 55(a) of the 1940 Act.

11. See Section 55(a) of the 1940 Act at paragraphs 1 through 3.


13. Id.

14. At the time of the enactment of the 1980 Amendments . . . “all privately held companies and, we estimate, two-thirds of all companies [would] fall within [the definition of an ‘eligible portfolio company’] . . . .” See Hearings before the Subcommittee on Consumer Protection and Finance of the Committee of Interstate and Foreign Commerce of the House of Representatives on H.R. 7554 and H.R. 7591 (June 17, 1980).

15. See H.R. Rep. 3170 (2004). The authors of this article have been involved in the legislative process pertaining to the proposed legislation.