The ABCs of Non-Listed BDCs
What is a Business Development Company?

- Created by the Small Business Investment Incentive Act of 1980 (the “1980 Amendments”) as a result of a perceived crisis in the capital markets in the 1970s.
- Private equity and venture capital firms believed the “small private investment company” exemption (Section 3(c)(1) of 1940 Act) limited their capacity to provide financing to small, growing businesses.
- Special type of closed-end fund:
  - Provides small, growing companies access to capital.
  - Enables private equity funds to access the public capital markets.
  - Non-listed BDC enables accredited retail investors to participate in the upside of pre-IPO investing, though with limited liquidity.
  - Traditional listed BDC may sell to all retail investors
- Hybrid between an operating company and an investment company.
What is a Business Development Company? (cont’d)

Traditional BDC model provides BDC with access to all retail investors
What are the Benefits of the BDC as an Investment Vehicle?

- Access to public capital markets
- Flow-through tax treatment
- Reduced burden under 1940 Act
- External model permits management fee and “carried interest” incentive fee structure
- Publicly available financial information through quarterly reporting
- Portfolio is typically diversified which reduces risk to investors associated with private equity investments
- Restrictions on leverage and affiliated transactions
How Did the BDC Industry Develop?

- Prior to 2003, the largest BDCs were primarily internally managed. This choice was a reflection of the success of the internally managed, income producing BDC model.
- In 2004, Apollo Investment Corporation raised $930 million in less than three months which ignited the BDC industry.
- There has been a steady stream of BDC IPOs since that period.
- Several non-listed BDCs have also been brought to market.
- The top 25 actively traded BDCs have approximately $25 billion in assets under management.
- In the past six months of 2011, BDCs have raised over $565 million in follow on equity transactions and $1.6 billion in convertible debt offerings in the 144A market.
How Did the Non-Listed BDC Industry Develop?

• REITs have successfully used unlisted model for years.
• In 2008, FS Investment Corporation launched the first unlisted BDC
  ▪ Affiliated with GSO / Blackstone
  ▪ Has raised over $757 million through a continuous offering
  ▪ FS Energy & Power Fund was recently declared effective
• Since 2008, seven non-listed BDCs have filed registration statements with the SEC.
• Unlisted BDCs have collectively raised over $1 billion since 2008.
Non-Listed BDC Activity

• The following unlisted BDCs are currently making continuous offerings:
  ▪ Business Development Corporation of America - $1.5 billion*
    ▪ Affiliated with American Realty Capital II
  ▪ Corporate Capital Trust, Inc. - $1.5 billion*
    ▪ Managed by CNL Fund Advisors Company and KKR Asset Management LLC
  ▪ FS Investment Corporation - $1.5 billion*
    ▪ Affiliated with GSO / Blackstone
  ▪ FS Energy and Power Fund - $1.5 billion*
    ▪ Affiliated with GSO / Blackstone
  ▪ Keating Capital Inc. - $100 million*

• The following unlisted BDCs have registration statements pending*:
  ▪ Gladstone Lending Corporation - $500 million*
  ▪ Chanticleer Dividend Fund - $125 million*

*Target fund size
How Does a Company Become a BDC?

- Organize the BDC as a Delaware or a Maryland corporation
- Register a class of securities under the 1934 Act
- Make an election to be a BDC- file a Form N-54A (Notification of election to be subject to sections 55 through 65 of the 1940 Act)
- Register a class of securities on Form N-2
- Comply with regulatory requirements of the 1940 Act
- Comply with the Sarbanes-Oxley Act of 2002 and Dodd-Frank Act
Additional Requirements For Non-Listed BDCs: Overview

• Suitability requirements
  ▪ May only be sold to accredited investors, typically through one or more distribution platforms

• FINRA review

• State blue sky review
  ▪ Must be approved to sell securities in each state where solicitations will occur, requiring compliance with the “Omnibus Guidelines” published by the National Association of State Securities Administrators ("NASAA")
  ▪ Completing blue sky process can take up to a year

• Continuous offering over a period of time
  ▪ 497 is filed monthly to report sales

• Liquidity Event
  ▪ Typically complete liquidity event within five to seven years following completion of offering
Additional Requirements For Non-Listed BDCs: “Blue Sky Laws”

• Liquidity Event (cont’d)
  ▪ Liquidity event could include: (1) sale of all or substantially all of company’s assets either on a complete portfolio basis or individually followed by a liquidation, (2) listing of company’s common shares on a national exchange, or (3) merger or another transaction approved by company’s board of directors in which shareholders receive cash or shares of a publicly traded company

• NASAA Omnibus Guidelines:
  ▪ Sponsor Requirements
    ▪ Sponsor must have adequate experience and net worth
    ▪ Limited indemnification of Sponsor, which may affect bylaws and/or charter of an issuer
  ▪ Suitability of Investors
    ▪ Default minimum suitability standards of either $70,000 gross income and $70,000 net worth or $250,000 net worth
    ▪ Suitability standards may vary across states
    ▪ Minimum investment amounts
    ▪ Suitability typically determined through subscription agreement
Additional Requirements For Non-Listed BDCs: “Blue Sky Laws”

- Fees, Compensation and Expenses
  - Sponsor’s compensation must be “reasonable”
    - For BDCs, compensation presumptively reasonable if limited to “participation in net gains” of the issuer
    - For Sponsor providing services to the issuer, fees must be competitive as compared to independent third-parties
  - Offering document must estimate and itemize fees and expenses

- Conflicts of Interest
  - Issuer may only invest in joint ventures or general partnerships with non-affiliates so long has “controlling interest”
  - Issuer may only invest in joint ventures or general partnerships with affiliated entities provided there are no duplication of fees and each investor has right of first refusal to buy the affiliates’ interests in the venture
  - Limited ability to invest in joint ventures or general partnerships with non publicly registered affiliates
  - Multi-tiered arrangements permissible so long not designed to circumvent the Guidelines, there are no duplication of fees, no decrease in the voting rights of stockholders and the fiduciary obligations of the various parties are adjusted
Additional Requirements For Non-Listed BDCs: “Blue Sky Laws”

- Rights and Obligations of Participants (i.e. Stockholders)
  - 10% holders have right to call stockholders meetings
  - Majority approval of stockholders required to amend entity charter, dissolve the company, remove the Sponsor, elect a new Sponsor or approve the sale of substantially all of the assets of the company
  - Stockholder right to inspect and copy the company’s records, including stockholder list
  - Reports to stockholders (e.g., 10-Qs and 10-Ks)
  - Distribution Reinvestment Plans (“DRPs”) may not charge sales commissions for shares issued under the DRP
    - Stockholders must be able to elect or revoke participation in the DRP
    - Stockholders participating in the DRP must receive “current” copy of the prospectus each time shares under the DRP are issued
    - Broker-dealers responsible for ensuring participants in the DRP remain “suitable” to invest in the issuer
Additional Requirements For Non-Listed BDCs: “Blue Sky Laws”

- Redemptions/Repurchases
  - Non-listed issuers typically offer to redeem or repurchase portion of outstanding shares on quarterly basis
  - Periodic tender offers by closed-end funds, including BDCs, excepted from Regulation M under the Securities Exchange Act of 1934 if made at net asset value or if the comply with Rule 23c-3 of the Investment Company Act of 1940
  - REITs received class exemption from Regulation M from the SEC for certain redemption plans
    - BDCs may receive similar relief
What Must a BDC Invest In?

- A BDC can generally invest with flexibility in assets ("bad assets") that do not fall within the "70% basket" if the investment:
- The SEC Staff has never been called upon to consider whether utilizing a specific strategy for the entire "30% basket," e.g., investing solely in foreign companies, might run afoul of the intent of Section 55(a)
- The 70% basket includes securities issued by an eligible portfolio company, as defined in Section 2(a)(46)
  - Eligible portfolio companies include:
    - U.S. issuers that are neither an investment company as defined in section 3 (other than a wholly-owned SBIC) nor a company which would be an investment company except for the exclusion from the definition of investment company in section 3(c) and
      - (i) do not have any class of securities listed on a national securities exchange; or
      - (ii) have a class of securities listed on a national securities exchange, but have an aggregate market value of outstanding voting and non-voting common equity of less than $250 million.
What are the Borrowing Limitations?

- **BDCs Must have 200% asset coverage (Total Assets/Total Debt)**
  - For example, a BDC with $50 in equity can borrow up to $50
  - A BDC would be able to invest $100 in growing businesses

- **Other investment companies are restricted to a 300% asset coverage requirement with respect to issuing debt**

- **BDCs may exclude leverage at the SBIC level if the Securities and Exchange Commission grants exemptive relief (e.g., Hercules Technology Capital Growth, Inc. and MCG Capital Corporation)**
Can a BDC Engage in Transactions with Affiliates?

- Section 57 addresses the ability of BDCs to engage in certain types of transactions with affiliates:
  - Section 57 is less onerous than its counterpart for registered investment companies, Section 17

- Depending on the nature of the affiliation with the BDC, transactions involving a BDC and one or more of its affiliates require either:
  - Authorization by the required majority of the board of directors, which consists of a majority of the board, including a majority of disinterested board members; or
  - An order of the Commission.
What are the 1940 Act Operational Requirements?

• **BDC must have a majority of independent directors** - persons who are not “interested persons” as defined in Section 2(a)(19) of the 1940 Act.

• **BDCs must make available significant managerial assistance to these companies**
  - SBICs generally already provide managerial assistance to the portfolio company

• **Custodian Agreement**
  - A BDC generally must place and maintain its securities and similar investments in the custody of a bank qualified under Section 26(a)(1) of the 1940 Act or a broker dealer.

• **Fidelity Bond**
  - A BDC must provide and maintain a bond issued by a reputable fidelity insurance company to protect the company against larceny and embezzlement. The bond must cover each officer and employee with access to securities and funds of the company.
What are the 1940 Act Operational Requirements? (con’t)

• Restrictions on Investing in Other Investment Companies
  ▪ A BDC may not invest:
    ▪ in more than 3% of the outstanding voting stock of an investment company;
    ▪ more than 5% of the value of its total assets in an investment company; or
    ▪ more than an aggregate of 10% of its total assets in investment companies.

• Restrictions on investment funds investing in a BDC
  ▪ Neither a public (i.e. registered) or private investment fund may own more than 3% of
    the outstanding voting stock of a BDC

• Code of Ethics

• Limitations on Indemnification
  ▪ A BDC is prohibited from protecting any director or officer against any liability to the
    company, 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.
What are the 1940 Act Operational Requirements? (con’t)

• Compliance Policies and Procedures for the BDC – Rule 38a-1
  ▪ Rule 38a-1 under 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.

• Compliance Policies and Procedures for the investment adviser – Rule 206(4)-7 of the Investment Advisers Act of 1940
  ▪ requires an investment adviser of a BDC to adopt and implement policies and procedures.

• Bookkeeping and Records Requirements - BDCs are required to maintain records

• Examinations by the SEC
What are the Reporting Requirements?

- Form 10-K (Annual Report)
- Form 10-Q (Quarterly Report)
- Form 8-K (Current Report)
- Proxy Statements
- Sections 13 and 16 Filings
  - Forms 3, 4 or 5 for reporting beneficial ownership by insiders
  - Schedules 13D and 13G for reporting beneficial ownership by others
- Regulation G and Regulation FD
- Comply with the Sarbanes-Oxley Act of 2002
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting/Attestation
How Are a BDC’s Assets Valued?

- Assets must be valued on a quarterly basis
  - Market value is used for those assets for which market quotations are readily available
  - “Fair value,” as determined by the board of directors, is used for other securities and assets
    - Each debt and equity security is separately valued
- There is no single standard for determining fair value in good faith
- Determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process
- ASC 820 requires that public companies’ financial instruments generally be valued at their current market price (i.e., “mark to market”)
How Can an Internally Managed BDC Compensate Management?

- Certain performance-based compensation permitted, including:
  - Issuance of at-the-market options, warrants, or rights pursuant to an executive compensation plan;
  - OR
  - Maintenance of a profit sharing plan.

- Otherwise, BDC must use cash assets as compensation
- Restricted stock – exemptive orders have been issued to BDCs to permit issuance of restricted stock (e.g., Hercules Growth Technology, Inc., MCG Capital Corporation and Main Street Capital Corporation)
How Can an Externally Managed BDC Compensate the Adviser?

• The investment adviser must be registered under the Investment Advisers Act of 1940
• The Advisers Act contains no prohibition against an adviser taking an incentive fee against income, although the market has effectively capped these fees at 20%, usually subject to a hurdle.
• 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.
How is the Adviser’s Incentive Fee Calculated?

• SEC Staff has taken no formal position on the calculation of the fee but requires BDCs to contain extensive disclosure in registration statements regarding the manner in which the fee will be calculated in varying scenarios.

• Section 205(b)(3) of the Advisers Act permits external investment advisers to BDCs to receive incentive fees, provided that the BDCs do not have outstanding any equity-based compensation arrangement or profit-sharing plan.
  - Section 205(b)(3) provides an exception from the general prohibition on an investment adviser charging an incentive fee based on a share of capital gains.
  - May assess an incentive performance fee of up to 20% on a BDC’s realized capital gains net of all realized capital losses and unrealized capital depreciation over a specified period.

• 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.
How are BDCs Taxed?

• A BDC may elect to be taxed as a regulated investment company (“RIC”) under the Internal Revenue Code
  ▪ Taxation as a RIC
    ▪ Allows “pass through” tax treatment for income and capital gains that are distributed to shareholders
    ▪ A BDC must distribute at least 90% of its investment income to shareholders annually
    ▪ The BDC may retain, distribute or “deem distribute” capital gains
    ▪ BDC must meet minimum source of income requirements annually and meet requirements on a quarterly basis with respect to the portfolio diversification
  ▪ Conversion to RIC status
Questions?

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