



## Legal Alert: Choice 2.0 and Its Impact on Business Development Companies

July 31, 2017

In April 2017, the full text of an updated version of the CHOICE Act (CHOICE 2.0) was released followed by a hearing on its contents. On June 8, 2017, the House Financial Services Committee released the draft of CHOICE 2.0, a version of which passed the House on June 8, 2017, as HR 10 (Rep. No. 115-153) (House CHOICE Bill). Included in CHOICE 2.0 and the House CHOICE Bill are various changes to regulations under the Investment Company Act of 1940, as amended (the 1940 Act), the Securities Act of 1933, as amended (the Securities Act), and the Securities Exchange Act of 1934, as amended (the Exchange Act), that could impact business development companies (BDCs).

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The chart below summarizes the proposed changes to current BDC regulation that are currently included in CHOICE 2.0 and the House CHOICE Bill:

Current Law	CHOICE 2.0	Impact on BDCs
<b>Ownership of Registered Investment Advisers</b>		
<p><b><u>Investment Company Act of 1940 (1940 Act) – Section 60</u></b> Section 60 of the 1940 Act generally prohibits a BDC from purchasing or otherwise acquiring any securities issued by an investment adviser of an investment company or a registered investment adviser unless the BDC receives exemptive relief.</p>	<p><b><u>Section 436(a)</u></b> The proposed legislation states that Section 12 of the 1940 Act will not apply to BDCs that acquire securities or any other interests in a registered investment adviser or in an investment adviser to a BDC or an investment adviser that is an eligible portfolio company.</p> <p>*However, the SEC may make rules addressing any potential conflicts of interest between investment advisers and BDCs.</p>	<p>The proposed legislation eliminates the need for BDCs to seek exemptive relief, leveling the playing field between BDCs that have been granted exemptive relief and those that have not.</p> <p>*Note that conflict of interest rules, if enacted, would apply.</p>
<b>Eligible Portfolio Company Revisions</b>		
<p><b><u>1940 Act – Section 55</u></b> Section 55 generally requires BDCs to hold at least 70% of their total value in certain “qualified assets,” including “eligible portfolio companies.” The definition of an eligible portfolio company excludes “investment companies” and companies that would be “investment companies” but for the exclusion provided under Section 3(c) of the 1940 Act.</p>	<p><b><u>Sections 436(b) and 436(c)</u></b> The proposed legislation allows BDCs to meet the 70% requirement by investing <b>up to 50%</b> of their assets in companies excluded from the definition of an “investment company” under Sections 3(c)(2), (3), (4), (5), (6), and (9).</p>	<p>The proposed legislation allows BDCs greater flexibility in meeting the 70% qualified assets requirement, and would allow some currently non-qualified financial services companies to be considered qualified assets.</p>

Current Law	CHOICE 2.0	Impact on BDCs
<b>Asset Coverage Limit Reductions</b>		
<p><b>1940 Act – Sections 18(a) and 61(a)</b></p> <ul style="list-style-type: none"> <li>BDCs may not issue any class of debt senior security or declare any cash dividend unless, immediately after the issuance, the BDC has asset coverage of at least 200%.</li> </ul>	<p><b>Section 437(a)</b></p> <ul style="list-style-type: none"> <li>The proposed legislation allows a BDC to issue debt senior securities and declare cash dividends so long as its asset coverage does not exceed 150%, and the BDC (i) adopts a 150% asset coverage requirement, and (ii) makes certain disclosures in an 8-K filing, on its website, and in its periodic reports.</li> <li>Additionally, if the BDC issues publicly traded equity securities, the company must: (i) make disclosures regarding the amount of debt outstanding, and (ii) make disclosures regarding the risks associated with such debt. The 150% asset coverage requirement may be approved by either shareholders (which approval is effective immediately), or a “requirement majority” of the non-interested directors. If approved by the board without a shareholder vote, the application of the 150% asset coverage limitation would not be effective until one year after approval for publicly traded BDCs. Non-traded BDCs would be required to repurchase up to 25% of the company’s shares in the four quarters following the board’s approval.</li> <li>The 200% asset coverage requirement is maintained for BDCs that do not meet the requirements above.</li> </ul>	<p>The proposed legislation allows BDCs to incur more leverage, enabling them to raise additional assets to invest in a greater number of small to mid-size US companies.</p>

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<b>Preferred Stock Revisions</b>		
<p><b>1940 Act – Sections 18(c), (i) and 61(a)</b></p> <ul style="list-style-type: none"> <li>• BDCs may issue warrants, options or rights to subscribe or convert to voting securities only.</li> <li>• All preferred stock issued by a BDC must include certain automatic rights, including, among other things:               <ul style="list-style-type: none"> <li>◦ The right to elect at least two directors at all times, and a majority of directors if preferred dividends are due but unpaid; and</li> <li>◦ Priority over other classes of stock, including priority at liquidation.</li> </ul> </li> </ul> <p>BDCs may not issue multiple classes of preferred stock.</p>	<p><b>Sections 437(b) and (c)</b></p> <ul style="list-style-type: none"> <li>• The proposed legislation allows BDCs to issue warrants, options or rights to subscribe or convert non-voting securities.</li> <li>• The proposed legislation allows preferred stock issued to “Qualified Institutional Buyers” (QIBs) to include fewer automatic rights. Such preferred stock is not required to include:               <ul style="list-style-type: none"> <li>◦ The right to elect at least two directors at all times, and a majority if dividends are unpaid;</li> <li>◦ Priority over other classes of stock as to distribution of assets upon liquidation; and</li> <li>◦ The right to have one class of preferred stock (i.e., multiple classes of preferred stock would have been allowed).</li> </ul> </li> </ul>	<p>The proposed legislation allows BDCs to offer different securities to sophisticated qualified institutional investors.</p>
<b>Multiple Share Classes</b>		
<p><b>1940 Act – Sections 18(c) and 61(a)</b></p> <p>As discussed above, Section 61(a), by reference to Section 18(c), prohibits BDCs from issuing multiple classes of preferred stock.</p>	<p><b>Sections 437(b) and (c)</b></p> <p>The proposed legislation allows BDCs to issue multiple classes of preferred stock to QIBs, subject to the applicable assets coverage ratio. As discussed above, preferred stock issued to QIBs would have been allowed to include fewer automatic rights.</p>	<p>The proposed legislation would grant BDCs better access to capital from QIBs, and would not be required to provide the same rights as preferred stock issued to retail investors.</p>

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<b>Registration and Reporting Parity</b>		
<p><b>Registration and Reporting Parity</b> BDCs' registration and reporting requirements are a mix of requirements under the 1940 Act and the Exchange Act. In certain contexts, a BDC may have to undertake greater reporting and registration efforts than other reporting companies under the Exchange Act.</p>	<p><b>Section 438(a)</b> The proposed legislation instructs the SEC to, within a year of enactment, issue rules or amendments to rules allowing BDCs to use the same "securities offering and proxy rules" that are available to reporting companies. These amendments would include the specific amendments detailed below.</p>	<p>As discussed below, the proposed legislation is intended to align the reporting, disclosure and filing obligations of BDCs with certain exemptions available to other reporting companies under the Exchange Act. In contrast to CHOICE 2.0, the House CHOICE Bill adds an extra layer of responsibility to ensure regulatory parity between BDCs and traditional reporting companies.</p>
<p><b>Automatic effectiveness after one year</b></p>	<p><b>Section 438(c)</b> Provides that BDCs will be able to treat the parity provisions regarding offering and proxy rules (discussed above) as being effective if the SEC does not revise the relevant rules within one year after the law is enacted until such time as the revisions are completed.</p>	<p>Ensures that the parity rules would be implemented or treated as implemented by a certain date.</p>
<p><b>Form N-2 – Incorporation by Reference</b> BDCs are required to file registration statements on Form N-2. While certain other filers that are allowed to register securities on Form S-3 may incorporate information into their prospectuses by reference to earlier or subsequently filed documents, Form N-2 does not allow incorporation by reference.</p>	<p><b>Section 438(b)</b> The proposed legislation instructs the SEC to, within a year of enactment, include instructions that allow for incorporation by reference in a manner similar to the instructions included in Form S-3.</p>	<p>The proposed legislation allows BDCs to raise capital more cheaply and efficiently, and respond to market conditions more quickly by having shorter registration statements and prospectuses. Investors are also able to readily access the most important information about an issuer.</p>

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<p><b><u>Securities Act of 1933 – Rules 168 and 169</u></b>            Rules 168 and 169 under the Securities Act allow both issuers that report under the Exchange Act and those that do not report under the Exchange Act to disseminate “regularly released factual business and forward-looking information,” even around the time of a registered offering. This safe harbor is designed to permit ongoing communications with the market that do not contain information about a potential offering and cannot be made as part of the offering process. Rules 168 and 169 specifically prohibit BDCs from relying on those rules.</p>	<p><b><u>Section 438(a)(2)</u></b>            The proposed legislation directs the SEC to permit BDCs to rely on Rules 168 and 169.</p>	<p>The proposed legislation allows BDCs to more easily communicate with the market without violating gun-jumping provisions. BDCs could release factual and forward-looking business information to the same extent as other market participants.</p>
<p><b><u>Securities Act of 1933 – Rules 134, 163A and 163</u></b>            BDCs are prohibited from relying on Rules 134, 163A and 163.</p> <ul style="list-style-type: none"> <li>• Rule 134 provides a safe harbor that allows issuers to make certain written statements regarding an offer after a prospectus is filed, provided certain conditions are met.</li> <li>• Rule 163A provides a safe harbor from the gun-jumping provisions for communications that do not reference an offering and that are made more than 30 days before a registration statement is filed, provided certain conditions are met.</li> <li>• Rule 163 is a safe harbor from the gun-jumping provisions that allows “Well-Known Seasoned Issuers” (WKSIs) to engage in unrestricted oral and written offers before filing a registration statement, provided certain conditions are met.</li> </ul>	<p><b><u>Sections 438(a)(3) and (4)</u></b>            The proposed legislation directs the SEC to revise Rules 134, 163A and 163 to allow BDCs to rely on such Rules.</p>	<p>The proposed legislation permits BDCs to release factual business information with more certainty, and to have more flexibility in communications with investors.</p>

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<p><b><u>Securities Act of 1933 – Rules 138 and 139</u></b> BDCs are not specifically permitted to rely on Rules 138 or 139.</p> <ul style="list-style-type: none"> <li>• Rule 138 permits a broker-dealer participating in a distribution of securities of an issuer to publish research reports about that issuer if certain conditions are met.</li> <li>• Rule 139 permits a broker-dealer participating in a distribution of securities of an issuer to publish research reports concerning that issuer or any class of its securities if certain conditions are met.</li> <li>• Research reports permitted by Rules 138 and 139 will not be considered general advertising or solicitation for purposes of Rule 144A offerings.</li> </ul>	<p><b><u>Section 438(a)(5)</u></b> The proposed legislation directs the SEC to revise Rules 138 and 139 to specifically include BDCs as issuers to which the Rules apply.</p>	<p>The proposed legislation permits broker-dealers and other providers of market research more flexibility to disseminate research on BDCs and allows more communication of information to the market about BDCs.</p>
<p><b><u>Securities Act of 1933 – Rule 405</u></b> SEC Rules allow WKSIs to benefit from a more flexible registration process, which includes, among other things, automatic effectiveness of a WKSI's registration statement, and reduced information included in the registration statement. BDCs are prohibited from qualifying as WKSIs, and Form N-2 may not receive automatic shelf registration (which applies only to registration statements filed on Form S-3).</p>	<p><b><u>Section 438(a)(1)</u></b> The proposed legislation directs the SEC to revise Rule 405 to remove the exclusion for BDCs from the definition of a WKSI, and to add Form N-2 to the definition of automatic shelf registration.</p>	<p>The proposed legislation allows BDCs to file automatic shelf registrations to take advantage of frequently changing market windows, and other benefits applicable to WKSIs.</p>
<p><b><u>Securities Act of 1933 – Rules 433 and 164</u></b> Rule 433 generally permits issuers to use free writing prospectuses after a prospectus has been filed. Rule 164 provides a safe harbor from the gun-jumping provisions and the failure to qualify under Rule 433 for "immaterial or unintentional" deviations from the safe harbor rules. BDCs are prohibited from relying on Rule 164.</p>	<p><b><u>Sections 438(a)(6) and 438(7)</u></b> The proposed legislation directs the SEC to revise Rule 433 to specifically state that BDCs that qualify as WKSIs can rely on the Rule. Additionally, the proposed legislation would allow BDCs to rely on Rule 164.</p>	<p>The proposed legislation allows BDCs that qualify as WKSIs to use free writing prospectuses, which allow for greater communication with the market, including information that may not be included in the registration statement. BDCs would benefit from a safe harbor for unintentional violations of the gun-jumping provisions.</p>

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<p><b><u>Securities Act of 1933 – Rule 415</u></b></p> <ul style="list-style-type: none"> <li>• Rule 415 provides the basis for shelf registration, and specifically lists the types of shelf offerings that may be effected on an immediate, a delayed or a continuous basis. Rule 415 limits the amount of securities that can be registered for a continuous offering to two years for registration statements not filed on Form S-3. Other provisions of Rule 415 are applicable registrants using Form S-3.</li> <li>• For registration statements on Form N-2, Rule 415 requires registrants to provide an undertaking (contained in Item 34.4 of Form N-2) “to file, during any period in which offers or sales are being made, a post-effective amendment to the registration statement: (1) to include any prospectus required by Section 10(a)(3) of the 1933 Act.”</li> </ul>	<p><b><u>Section 438(a)(8)</u></b></p> <ul style="list-style-type: none"> <li>• The proposed legislation directs the SEC to revise Rule 415 to specifically state that registration for securities provided for in Rule 415 includes BDC securities registered on Form N-2.</li> <li>• BDCs would not be required to make the undertaking in Item 34.4 of Form N-2.</li> </ul>	<p>The proposed legislation allows for SEC review of BDC N-2 shelf registration statements in advance of accessing public markets and offers more certainties with respect to timing.</p>
<p><b><u>Securities Act of 1933 – Rule 497</u></b></p> <ul style="list-style-type: none"> <li>• Rule 424(b), which is not applicable to BDCs, allows form prospectus supplements to be filed that contain only substantive changes from or additions to previously filed prospectuses.</li> <li>• Rule 497, which is applicable to BDCs, does not allow for form prospectuses.</li> </ul>	<p><b><u>Section 438(9)</u></b></p> <p>The proposed legislation directs the SEC to revise Rule 497 to include a parallel rule allowing BDCs to file form prospectus supplements under Rule 497.</p>	<p>The proposed legislation reduces the filing burden on BDCs, synchronizes BDC prospectus filing requirements with those of other registrants, and saves considerable time and money.</p>
<p><b><u>Securities Act of 1933 – Rules 172 and 173</u></b></p> <p>BDCs are prohibited from relying on Rules 172 and 173.</p> <ul style="list-style-type: none"> <li>• Rule 172 exempts an issuer or broker-dealer from delivering a prospectus in connection with a registered offering, so long as the final prospectus is filed with the SEC.</li> <li>• Rule 173 requires that each underwriter or dealer participating in a registered offering must provide to each purchaser a copy of the final prospectus or, in lieu of the final prospectus, a notice that the sale was made pursuant to a registration statement, within two business days following the completion of such sale.</li> </ul>	<p><b><u>Section 438(10)</u></b></p> <p>The proposed legislation directs the SEC to revise Rules 172 and 173 to remove the exclusion for BDCs.</p>	<p>The proposed legislation permits BDCs greater flexibility in the sales process in parity with other issuers covered by the rule, and reduces the prospectus delivery burden and costs associated with offerings.</p>



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<p><b><u>Securities Act of 1933 – Rule 418</u></b> Rule 418(a)(3) exempts already registered entities from having to provide certain supplemental engineering, management or other reports to the SEC upon request, on the basis that they are already registered and have complied with the requirements in General Instruction I.A. of Form S-3.</p>	<p><b><u>Section 438(11)</u></b> The proposed legislation directs the SEC to revise Rule 418 to provide that a BDC that meets the eligibility requirements under General Instruction I.A. of Form S-3 shall be exempt from Rule 418(a)(3).</p>	<p>The proposed legislation removes the obligation of BDCs to be ready to supply certain supplemental material upon request from the SEC, in line with the obligations of already registered issuers compliant with General Instruction I.A. of Form S-3.</p>
<p><b><u>Securities Exchange Act of 1934 – Rule 14a-101</u></b> Item 13 of Schedule 14A (information required in a proxy statement) allows previously filed financial reports to be incorporated by reference in any proxy statement for issues of securities or exchange offerings, as directed by Rule 14a-101.</p>	<p><b><u>Section 438(12)</u></b> The proposed legislation directs the SEC to revise Rule 14a-101 to provide that a BDC that meets the eligibility requirements under General Instruction I.A. of Form S-3 shall be deemed to meet the requirements of Form S-3 for the purposes of Schedule 14A.</p>	<p>The proposed legislation allows BDCs to incorporate previously filed financial statements into proxy statement forms, bringing the BDC's obligations into line with already registered issuers compliant with General Instruction I.A. of Form S-3.</p>
<p><b><u>Securities Exchange Act of 1934 – Rule 103 under Regulation FD</u></b> Rule 103 clarifies that a failure to make public disclosure under Regulation FD shall not affect whether a registered issuer, for the purposes of Forms S-2, S-3, S-8 and SF-3, is deemed to have filed all material required to be filed pursuant to sections 13 or 15(d) of the Exchange Act.</p>	<p><b><u>Section 438(13)</u></b> The proposed legislation would direct the SEC to revise Rule 103 to provide that Rule 103(a) applies to BDCs for the purposes of Form N-2.</p>	<p>The proposed legislation aligns BDCs' reporting obligations with those of other reporting companies under the Exchange Act, whereby a failure to disclose material information under Regulation FD would not affect the validity of a later Form N-2 registration statement.</p>

*If you have any questions about this legal alert, please feel free to contact any of the attorneys listed under 'Related People/Contributors' or the Eversheds Sutherland attorney with whom you regularly work.*