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Proposed Legislation for Business Development Companies H.R. 5929: A Capital Increase for Business Development Companies

Business Development Companies (BDCs) are an increasingly important source of funding for small and mid-sized U.S. companies with limited access to traditional capital markets. On June 8, 2012, Representative Michael M. Grimm (R-N.Y.) joined Representative Nydia Velazquez (D-NY) in introducing the Next Steps for Credit Availability Act (H.R. 5929).[1] The bipartisan bill aims to increase the availability of funding to small to mid-level companies and startups by increasing the capital available to BDCs and reducing certain regulatory burdens on BDCs.[2] By "modernizing the BDC regulatory framework," Representatives Grimm and Velazquez hope to "provide financial fuel for young, rapidly growing companies."[3] H.R. 5929 currently sits in the House Committee on Financial Services awaiting a favorable report.

Overview

BDCs are closed-end investment companies designed to facilitate capital raising by small and mid-sized U.S. businesses. They are subject to requirements under the Investment Company Act of 1940, as amended (the 1940 Act) that are, in many cases, less onerous than the provisions of the 1940 Act applicable to traditional closed-end investment companies.[4] Nevertheless, certain aspects of the regulatory scheme governing BDCs limit their ability to invest efficiently in small and mid-sized companies. In particular, 1940 Act limitations on borrowings and other forms of leverage and a prohibition on investing in a registered investment adviser have been seen to have impeded BDCs from more extensive investments in small and mid-size businesses. In addition, unlike traditional closed-end funds, BDCs are required to register under the Securities Act of 1933, as amended (the 1933 Act) as well as the 1940 Act. As such, they are subject to registration and related requirements under the 1933 Act as well as reporting requirements under the Securities Exchange Act of 1934, as amended (the 1934 Act). Currently, certain 1933 Act rules that facilitate capital raising by operating companies are not available to BDCs or are applied to BDCs in a less favorable manner than to other 1933 Act registrants.

H.R. 5929 attempts to promote capital raising by small- and mid-sized companies by making capital more readily available to BDCs to invest in their target companies. If enacted in its current form, H.R. 5929 would amend

1 Next Steps for Credit Availability Act, H.R. 5929 112th Cong. (2012).

2 Press Release, U.S. Congressman Michael Grimm, 13th District of N.Y. (June 11, 2012).

3 *Id.*

4 Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006).

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Sections 60 and 61 of the 1940 Act[5] and compel the Securities Exchange Commission (SEC) to amend certain rules under the 1933 Act to:

- permit BDCs to own interests in registered investment advisers;
- loosen the 1940 Act leverage limits applicable to BDCs by (a) reducing the asset coverage requirements for indebtedness from 200% asset coverage to 150% asset coverage (equivalent to a 66-2/3% debt-to-total capital ratio); (b) facilitating the issuance of multiple classes of senior securities, regardless of whether such securities constitute indebtedness or "stock"; and (c) eliminating asset coverage and other requirements applicable to senior (i.e., preferred) stock.
- reduce disparities in treatment for BDCs as compared to other 1933 Act registrants related to offering and reporting requirements, streamlining securities registration and reporting for BDCs, including permitting incorporation by reference and more flexible shelf registration requirements for larger, more established BDCs.

The Next Steps for Credit Availability Act

H.R. 5929 Section 2: Amendments to Permit BDCs to Own Registered Investment Advisers

Currently, the 1940 Act prevents BDCs (as well as other registered investment companies) from owning any interest in a registered investment adviser.[6] H.R. 5929 would except BDCs from this prohibition, although it would continue to apply to registered investment companies other than BDCs.

The importance of this proposed amendment results from changes to the Investment Advisers Act that were enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). Prior to the enactment of the Dodd-Frank Act, an investment adviser having fewer than 15 clients could generally avoid registration under the Advisers Act, and BDCs could and did own unregistered investment advisers.[7] BDCs typically used this flexibility to form and manage captive investment advisers that would manage investments on behalf of third party investors or the BDC itself, permitting stockholders in the BDC to benefit from the stream of advisory fees generated by such investment advisers. Following implementation of the Dodd-Frank Act, which repealed this registration exemption for "private advisers," BDCs owning (or wishing to acquire) a registered investment adviser must apply to the SEC for exemptive relief. If H.R. 5929 is enacted, it would no longer be necessary for BDCs to seek such exemptive relief, leveling the playing field between those BDCs that have been granted exemptive relief and those that have not.

The proposed amendments to Section 60 of the 1940 Act, marked to show changes from the current text, is included as **Exhibit A**.

H.R. 5929 Section 3: Amendments to Increase BDC Leverage

Asset Coverage

The 1940 Act's asset coverage requirements limit the ability of BDCs to incur leverage. As a result, BDCs typically incur much lower levels of leverage than private funds such as hedge funds or private equity funds, small business investment companies (SBICs) and operating companies. Under the asset coverage requirements of the 1940 Act, a BDC currently cannot borrow or issue a senior security unless, immediately following such borrowing or issuance, the BDC has asset coverage (total assets divided by total debt) of at least 200%, equivalent to a 50% debt-to-total capital ratio. H.R. 5929 would reduce this 200% asset coverage requirement for BDCs to 150%, equivalent to a 66-2/3% debt to total capital ratio.[8] Put another way, a BDC currently must hold two dollars in assets for every dollar borrowed; under the proposed amendments, the BDC would need only $1.50 in assets for each dollar borrowed. This reduction in the asset coverage requirements would allow BDC to incur more leverage, enabling them to raise additional assets to invest in small to mid-size U.S. companies, with a corresponding increase in the default risk associated with investments in BDCs.

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5 Exhibit A includes a marked changes version of these sections as they would read if H.R. 5929 is enacted in its current form.

6 Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 to -64 (2006), §60.

7 For an additional *DechertOnPoint* discussing the Dodd-Frank Act's impact on registration of investment advisers, see "SEC Adopts Final Rules Regarding Investment Adviser Registration and Amends Form ADV."

8 Compared with the 300% asset coverage requirement applicable to other types of investment companies, BDCs already enjoy a less restrictive regime.

Preferred Stock

The 1940 Act currently treats preferred stock similarly to other types of senior securities and imposes a number of restrictions on the issuance of preferred stock and similar securities. Among these are: (i) a 200% asset coverage requirement at issuance; (ii) prohibition on the declaration of dividends and distributions (other than those payable in the BDC's common stock) on the BDC's common stock, or repurchases of common stock, unless every class of senior securities of the BDC has, at such time, 200% asset coverage after giving effect to such dividend, distribution or repurchase; (iii) a requirement that holders of senior securities, voting as a class, may elect at least two directors of the BDC (subject under certain circumstances to the rights of the holders of other classes of senior securities to elect a majority of such directors) if more than a threshold amount of dividends remains in arrears; (iv) such class of senior stock has complete priority over any other class of capital stock as to the distribution of assets and the payment of (cumulative) dividends. H.R. 5929 would facilitate the issuance of senior securities that constitute "stock." In particular, H.R. 5929 (i) eliminates the asset coverage and other requirements described above and (ii) permits BDCs to issue multiple classes of preferred stock.[9] These changes would make it easier for BDCs to raise additional capital through the issuance of preferred stock while still satisfying asset coverage requirements of the 1940 Act. However, it would appear that preferred stock would still be treated as a senior security for purposes of the asset coverage requirement applicable to senior debt securities and borrowings, which could result in different results under the asset coverage test depending on the sequence of security issuances by BDCs.

The proposed amendments to Section 61, marked to show changes from the current text, is included as **Exhibit B**.

[9] Closed-end funds that are not BDCs cannot issue more than one class of senior security. Currently, BDCs may issue multiple classes of senior securities that constitute indebtedness but only one class of senior securities that constitute stock.

H.R. 5929 Section 4: Registration Parity for BDCs

Finally, H.R. 5929 would streamline the SEC registration and reporting requirements applicable to BDCs by requiring the SEC to revise relevant rules and forms so that a BDC can "use the securities offering rules that are available to other 1934 Act registrants."[10] Currently, for example, BDCs: (i) are excluded from the definition of "well-known seasoned issuer," or WKSI, and thus cannot enjoy the benefits of such status, such as enjoying flexibility to add different types of securities to an effective shelf registration statement; (ii) file on Form N-2, which is not within the definition of "automatic shelf registration statement," so that even established BDCs must undergo a full SEC review of even routine registration statement filings; (iii) cannot benefit from universal registration by incorporating prior SEC filings into a registration statement by reference as other 1934 Act registrants have done for several decades. H.R. 5929 would require the SEC to amend relevant rules under the 1933 and 1934 Acts to grant BDCs the registration and reporting benefits available to other 1934 Act registrants. A chart detailing these rules is included as **Exhibit C**.

Conclusion

H.R. 5929 aims to facilitate capital formation by BDCs, thereby increasing the availability of funding for small to mid-size U.S. companies and startups, by increasing the amount of leverage BDCs may incur, permitting BDCs more flexibility to issue senior, or preferred, stock and by conforming BDC registration and reporting to established norms for other public companies. The passage of H.R. 5929 would have broad, favorable implications for the BDC industry; however its enactment appears uncertain in the current legislative environment.

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[10] H.R. 5929 § 4.

EXHIBIT A

H.R. 5929: AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

FUNCTIONS AND ACTIVITIES OF BUSINESS DEVELOPMENT COMPANIES

Sec. 60. Notwithstanding the exemption set forth in section 6(f), section 12 shall apply to a business development company to the same extent as if it were a registered closed-end investment company, except that section 12 shall not apply to the purchasing, otherwise acquiring, or holding by a business development company of any security issued by, or any other interest in the business of, any person who is an investment adviser registered under title II of this Act or who is an investment adviser to an investment company; and the Commission shall not prescribe any rule, regulation, or order pursuant to section 12(a)(1) governing the circumstances in which a business development company may borrow from a bank in order to purchase any security.

(Aug. 22, 1940, ch. 686, title I, Sec. 60, as added Pub. L. 96-477, title I, Sec. 105, Oct. 21, 1980, 94 Stat. 2285.)

EXHIBIT B

H.R. 5929: AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

CAPITAL STRUCTURE

Sec. 61. (a) Notwithstanding the exemption set forth in section 6(f), section 18 shall apply to a business development company to the same extent as if it were a registered closed-end investment company, except as follows:

1. The asset coverage requirements of section 18(a)(1) (A) and (B) applicable to business development companies shall be ~~200~~ 150 per centum.

2. Notwithstanding section 18(c), a business development company may issue more than one class of senior security representing indebtedness or which is a stock.

3. Notwithstanding section 18(d)—

   A. a business development company may issue warrants, options, or rights to subscribe or convert to voting securities of such company, accompanied by securities, if—

      i. such warrants, options, or rights expire by their terms within ten years;

      ii. such warrants, options, or rights are not separately transferable unless no class of such warrants, options, or rights and the securities accompanying them has been publicly distributed;

      iii. the exercise or conversion price is not less than the current market value at the date of issuance, or if no such market value exists, the current net asset value of such voting securities; and

      iv. the proposal to issue such securities is authorized by the shareholders or partners of such business development company, and such issuance is approved by the required majority (as defined in section 57(o)) of the directors of or general partners in such company on the basis that such issuance is in the best interests of such company and its shareholders or partners;

   B. a business development company may issue, to its directors, officers, employees, and general partners, warrants, options, and rights to purchase voting securities of such company pursuant to an executive compensation plan, if—

i. (I) in the case of warrants, options, or rights issued to any officer or employee of such business development company (including any officer or employee who is also a director of such company), such securities satisfy the conditions in clauses (i), (iii), and (iv) of subparagraph (A); or (II) in the case of warrants, options, or rights issued to any director of such business development company who is not also an officer or employee of such company, or to any general partner in such company, the proposal to issue such securities satisfies the conditions in clauses (i) and (iii) of subparagraph (A), is authorized by the shareholders or partners of such company, and is approved by order of the Commission, upon application, on the basis that the terms of the proposal are fair and reasonable and do not involve overreaching of such company or its shareholders or partners;

ii. such securities are not transferable except for disposition by gift, will, or intestacy;

iii. no investment adviser of such business development company receives any compensation described in section 205(a)(1) of title II of this Act, except to the extent permitted by paragraph (1) or (2) of section 205(b); and

iv. such business development company does not have a profit-sharing plan described in section 57(n); and

C. a business development company may issue warrants, options, or rights to subscribe to, convert to, or purchase voting securities not accompanied by securities, if—

i. such warrants, options, or rights satisfy the conditions in clauses (i) and (iii) of subparagraph (A); and

ii. the proposal to issue such warrants, options, or rights is authorized by the shareholders or partners of such business development company, and such issuance is approved by the required majority (as defined in section 57(o)) of the directors of or general partners in such company on the basis that such issuance is in the best interests of the company and its shareholders or partners.

Notwithstanding this paragraph, the amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights at the time of issuance shall not exceed 25 per centum of the outstanding voting securities of the business development company, except that if the amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights issued to such company's directors, officers, employees, and general partners pursuant to any executive compensation plan meeting the requirements of subparagraph (B) of this paragraph would exceed 15 per centum of the outstanding voting securities of such company, then the total amount of voting securities that would result from the exercise of all outstanding warrants, options, and rights at the time of issuance shall not exceed 20 per centum of the outstanding voting securities of such company.

4. For purposes of measuring the asset coverage requirements of section 18(a), a senior security created by the guarantee by a business development company of indebtedness issued by another company shall be the amount of the maximum potential liability less the fair market value of the net unencumbered assets (plus the indebtedness which has been guaranteed) available in the borrowing company whose debts have been guaranteed, except that a guarantee issued by a business development company of indebtedness issued by a company which is a wholly-owned subsidiary of the business development company and is licensed as a small business investment company under the Small Business Investment Act of 1958 shall not be deemed to be a senior security of such business development company for purposes of section 18(a) if the amount of the indebtedness at the time of its issuance by the borrowing company is itself taken fully into account as a liability by such business development company, as if it were issued by such business development company, in determining whether such business development company, at that time, satisfies the asset coverage requirements of section 18(a).

5. Section 18(a)(2) shall not apply to a business development company. (b) A business development company shall comply with the provisions of this section at the time it becomes subject to sections 55 through 65, as if it were issuing a security of each class which it has outstanding at such time.

(Aug. 22, 1940, ch. 686, title I, Sec. 61, as added Pub. L. 96-477, title I, Sec. 105, Oct. 21, 1980, 94 Stat. 2286; amended Pub. L. 104290, title V, Sec. 506, Oct. 11, 1996, 110 Stat. 3446; Pub. L. 111203, title IX, Sec. 985(d)(5), July 21, 2010, 124 Stat. 1934.)

EXHIBIT C

H.R. 5929 SECTION 4: REGISTRATION PARITY FOR BUSINESS DEVELOPMENT COMPANIES (BDCS) RULES UNDER THE SECURITIES ACT OF 1933 (THE 1933 ACT)

Rule(s)	Current Operation	Change and Effect
Rule 405	Rule 405: Definitions of Terms Rule 405: excludes BDCs from the definition of “well-known seasoned issuer”; and omits Form N-2 from the definition “automatic shelf registration statement.”	*Change:* Instructs the SEC to revise Rule 405 to remove the exclusion of BDCs from the definition of “well-known seasoned issuer” and add registration statements filed on Form N-2 to the definition of “automatic shelf registration statement.” *Effect:* The proposed changes would permit BDCs to qualify as well-known seasoned issuers (WKSIs). WKSIs face less stringent disclosure and communication requirements. For example, many rules exempt WKSI communications from the “gun-jumping” restrictions of Section 5 of the 1933 Act. The proposed changes would also allow BDCs qualifying as WKSIs to file automatic shelf registrations. Automatic shelf registrations become effective upon filing, offering a quicker registration process.
Rules 168 & 169	Rule 168 provides reporting companies a safe harbor from Sections 5(c) and 2(a)(10) of the 1933 Act for certain factual business communications and forward looking information. Rule 169 provides a similar, but more limited, safe harbor for non-reporting companies.	*Change:* Instructs the SEC to revise Rules 168 and 169 to remove the exclusion of BDCs. *Effect:* The proposed changes would permit BDCs to release factual business information with more certainty. Reduction in potential prospectus liability would offer BDCs more flexibility in communicating to the investor community.

Rule(s)	Current Operation	Change and Effect
Rules 163 & 163A	Rule 163 provides WKSIs a safe harbor from Section 5(c)'s prohibition on pre-filing offers if certain conditions are met (ex. filing of a prescribed legend). Rule 163A provides issuers a safe harbor from Section 5(c)'s prohibition on pre-filing offers for communications made more than 30 days before the filing of a registration statement.	*Change:* Instructs the SEC to revise Rules 163 and 163A to remove the exclusion of BDCs. *Effect:* The proposed changes would reduce a BDC's potential for prospectus liability under the 1933 Act by allowing BDCs greater flexibility in communications.
Rule 134	Rule 134 provides a safe harbor that allows an issuer to make certain communications during the waiting period (the period between initial provision of the registration statement to the SEC and when the SEC declares the registration effective) of the public registration process.	*Change:* Instructs the SEC to revise Rule 134 to remove the exclusion of BDCs. *Effect:* The proposed change would reduce a BDC's potential for prospectus liability under the 1933 Act by permitting BDCs greater flexibility in communications. For example, issuers commonly use Rule 134 to safely issue press releases and advertisements.
Rules 138 & 139	Rules 138 and 139 provide safe harbors for brokers and dealers that provide market analysis to the investor community. Publications, distributions or reports within either rule will not constitute offers to/for sale under Sections 2(a)(10) and 5(c) of the 1933 Act.	*Change:* Instructs the SEC to revise Rules 138 and 139 to specifically include BDCs. *Effect:* Brokers and dealers will be better able to provide coverage and analysis of BDC securities.
Rule 164	Rule 164 provides a safe harbor for issuers that utilize post-filing free writing prospectuses. For instance, an unintentional or immaterial failure to comply with legend, filing or retention requirements meeting the requirements of Rule 164 may be curable.	*Change:* Instructs the SEC to revise Rule 164 to remove the exclusion of BDCs. *Effect:* BDCs would be able to communicate to potential investors through free writing prospectuses.

Rule(s)	Current Operation	Change and Effect
Rule 433	Rule 433 provides guidelines for when seasoned issuers, well-known seasoned issuers, non-reporting issuers, and unseasoned issuers can utilize post-filing free writing prospectuses.	*Change:* Instructs the SEC to revise Rule 433 to specifically include BDCs. *Effect:* BDCs that qualify as well-known seasoned issuers would be able to utilize free-writing prospectuses after filing a registration statement as long as the registration statement contains a preliminary or base prospectus.
Rule 415	Rule 415 specifies which offerings qualify for shelf registration and imposes certain obligations to remain qualified under the rule. For instance, Rule 415 requires issuers to update their prospectuses to disclose fundamental changes.	*Change:* Instructs the SEC to revise Rule 415 to: state that the registration of securities pursuant to that rule includes securities by a business development company on Form N-2; and provide an exception for a BDC from the requirement that a Form N-2 registrant must furnish the undertakings required by item 34.4 of Form N-2. *Effect:* BDCs would be able to utilize continuous or delayed offerings.
Rule 497	Rule 497 governs when investment companies must file prospectuses during the registration process.	*Change:* Instructs the SEC to revise Rule 497 to include a process for a BDC to file a form of prospectus that is parallel to the process for filing a form of prospectus under Rule 424(b). *Effect:* Rule 424(b) provides requirements for post-effective filings of prospectuses. Prospectuses and supplements prepared and given to investors after the SEC has declared the registration effective must be filed in accordance with one of eight subsections of Rule 424(b).

Rule(s)	Current Operation	Change and Effect
Rules 172 & 173	Rule 172 exempts written confirmations of sales, notifications of allocations, and deliveries of securities from the prospectus delivery requirements of Section 5(b)(1) of the 1933 Act if the issuer has already filed the final prospectus with the SEC or makes a good faith effort to file a final prospectus within the time frame required by Rule 424. Rule 173 allows an issuer, underwriter or broker to provide to purchasers, upon completion of a sale, either: a copy of the final prospectus; or a notice that the sale was made pursuant to a valid registration statement.	*Change:* Instructs the SEC to revise rules 172 and 173 to remove the exclusion of BDCs. *Effect:* The proposed change would permit BDCs greater flexibility in the sales process in parity with other issuers covered by the rule.

REVISIONS TO FORM N-2

Form	Current Operation	Change and Effect
N-2	BDCs use Form N-2 to register their shares under the 1933 Act. Presently, a BDC's registration statement on Form N-2 must contain in the document all information that investors must be provided, whereas other issuers are permitted to incorporate information, such as their financial statements, by including in the registration statement a reference to where the required information is publicly available in another SEC filing.	*Change:* Instructs the SEC to include instructions in Form N-2: to provide that any BDC that meets the requirements of Form S-3 shall incorporate by reference its reports and documents filed under the 1934 Act into its registration statement filed on Form N-2. to provide that a BDC that is a well-known seasoned issuer may file automatic shelf offerings on Form N-2 (or any successor form). *Effect:* The proposed changes would permit BDCs to incorporate information that they already file under the 1934 Act into the registration process. Incorporation would enhance the efficiency with which BDCs register securities. Furthermore, the changes would allow BDCs that qualify well-known seasoned issuers to file automatic shelf offerings on Form N-2. Automatic offerings would provide BDCs with more options in choosing when to offer securities.

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