

Overview

Business development companies (“BDCs”) are U.S. publicly held investment funds that invest primarily in private and thinly traded public U.S. businesses. BDCs have generally faced capital raising challenges when seeking to issue new securities after their initial public offerings due to regulatory constraints imposed upon them by the Investment Company Act of 1940, as amended (the “1940 Act”). Unlike many other issuers of common stock, a BDC is not generally able to issue and sell shares of its common stock at a price below its net asset value (“NAV”) per share unless it has received prior approval from its shareholders. Historically, shares of common stock of BDCs frequently trade at a discount to NAV, thereby limiting the ability of BDCs to raise capital by issuing shares of common stock. Additionally, any debt or senior security issued by a BDC must have asset coverage of at least 200%. 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 in addition to the asset coverage test.

Notwithstanding the aforementioned regulatory constraints, a shelf registration statement can help a BDC overcome capital raising challenges that are related to the timing and certainty of a securities offering. A BDC can use a shelf registration statement on Form N-2 to register multiple offerings of securities in order to raise capital. An effective shelf registration statement enables a BDC to quickly access capital markets when needed or when market conditions are optimal. The shelf registration statement can be filed with the Securities and Exchange Commission (the “SEC”) and reviewed by the SEC staff while the BDC is trading at a discount to its NAV and then can be used to conduct an offering of the BDC’s shares of common stock when market conditions permit. Takedowns from an effective shelf registration can then be consummated without SEC staff review or delay. As a result, an effective shelf registration statement permits a BDC to offer its shares of common stock to the general public at a price above or at NAV when the BDC is trading at a sufficient premium. This is particularly useful for BDCs seeking to raise capital that trade at a premium to NAV for only a short and typically unpredictable period of time.

The SEC has recently imposed a limit on the cumulative dilution to a BDC’s current NAV per share that a BDC may incur while using a shelf registration statement to sell shares of common stock at a price below NAV. A BDC can complete multiple offerings off of an effective shelf registration statement only to the extent that the cumulative dilution to the BDC’s NAV per share does not exceed 15%. Once the cumulative dilution exceeds 15%, the BDC must file a post-effective amendment to the shelf registration statement or file a new shelf registration statement. A BDC also must provide, in the related prospectus supplement for the offering, specific dilution tables showing the dilutive or accretive effects that the offering will have on different types of investors and a chart based on the number of shares of common stock offered, as well as the discount to the most recently determined NAV.

N-2 Shelf Registration Requirements

Securities may be registered by a BDC on Form N-2 for an offering to be made on an immediate, continuous or delayed basis pursuant to Rule 415 under the Securities Act of 1933, as amended (the “Securities Act”), so long as:

- the BDC is organized or incorporated under the laws of the United States or any state or territory or the District of Columbia and has its principal business operations in the United States or its territories;
- the BDC has a class of shares that is required to be registered pursuant to Section 12(b) or 12(g) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or the BDC is subject to the reporting requirements of Section 15(d) of the Exchange Act;
- the BDC is subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed with the SEC all material required to be filed pursuant to Section 13, 14 or 15(d) of the Exchange Act for a period of at least 12 calendar months prior to the shelf registration statement filing;
- the BDC has filed with the SEC in a timely manner all reports required to be filed during that 12-month period (other than certain current reports on Form 8-K);
- the BDC has not (i) failed to pay any dividend or sinking fund installment on preferred stock or (ii) defaulted on any installment for indebtedness for borrowed money or on any rental on long-term leases, in each case, since its last fiscal year-end; and

- the aggregate market value of the voting and non-voting common equity held by non-affiliates of the BDC is at least \$75 million.

N-2 Shelf Registration Statement Limitations

While Form S-3 permits shelf registration statements of “well-known seasoned issuers” (“WKSIs”) to be automatically effective upon filing, BDCs are expressly excluded from the statutory definition of a WKSI, pursuant to Rule 405 of the Securities Act. Therefore, shelf registration statements of BDCs are not effective automatically upon filing. Additionally, Form S-3 allows a company to incorporate by reference the disclosure from its current and future Exchange Act reports to satisfy the disclosure requirements of the Form. Incorporation by reference occurs when disclosure in one filed document is legally deemed to be included in another document. Incorporation by reference is central to the SEC’s “integrated disclosure” framework. The rationale for incorporation by reference is that disclosure that is available to investors does not necessarily need to be repeated in each disclosure document. Unfortunately, BDCs must register their shelf securities on Form N-2 (as opposed to Form S-3), which currently does not allow periodic reports to be incorporated by reference. As a result of its inability to forward incorporate by reference periodic reports, in order to maintain a BDC’s shelf registration statement, a BDC is required to file a post-effective amendment to its shelf registration statement to reflect in the prospectus any facts or events that represent a material change or omission in the information set forth in the registration statement, including the BDC’s quarterly and annual reports.

In June 2015, the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Financial Services Committee conducted hearings with respect to a draft bill titled ‘The Small Business Credit Availability Act’ that would require, among other things, the SEC to amend Form N-2 to allow BDCs to (i) file automatic shelf offerings for BDCs that qualify as WKSIs and (ii) incorporate by reference reports and documents that they have filed with the SEC under the Exchange Act. If enacted and adopted, the changes included in the bill would streamline the registration process and give BDCs more flexibility in conducting public offerings and raising capital.

Additionally, a BDC is not permitted to use a free writing prospectus or an electronic roadshow. Instead, a BDC must use advertisement materials pursuant to Rule 482 under the Securities Act to communicate certain information to potential investors. “Access equals delivery” under Rule 172 under the Securities Act, which deems electronic availability of the prospectus equivalent to physical delivery in certain circumstances, also is not available to BDCs.

SEC Review Process for a BDC

As noted above, a BDC’s shelf registration statement is not permitted to become effective automatically upon filing. As such, the SEC staff typically reviews a BDC’s shelf registration statement filing. The typical SEC review process for an initial shelf registration statement takes approximately 30 to 45 days from the initial filing. As part of the initial shelf registration statement filing, a BDC will typically include a “base” prospectus that complies with the applicable Form N-2 disclosure requirements and enables the shelf registration statement to go effective. The “base” prospectus provides prospective investors with a general description of the offerings of securities that a BDC may conduct pursuant to the shelf registration statement. The SEC staff typically provides comments on the initial filing, and the BDC must respond to those comments in writing and file a pre-effective amendment to the registration statement reflecting the agreed-upon changes. When all comments have been satisfactorily resolved, the BDC submits an acceleration request and the SEC staff declares the shelf registration statement effective. The effective shelf registration statement can only be used for three years (subject to a limited extension) after its initial effective date. Under the current rules, new shelf registration statements must be filed every three years, with unsold securities and fees paid under an “expiring” registration statement rolled over to the new registration statement.

BDC Shelf Offerings

Under the shelf registration process, which constitutes a delayed offering in reliance on Rule 415 under the Securities Act, a BDC may offer, from time to time, in one or more offerings, up to an expressed maximum aggregate amount of its registered securities. The securities registered may include common stock, preferred stock, warrants (representing rights to purchase shares of common stock), subscription rights, or debt securities, on terms to be determined at the time of the offering. The securities may be offered at prices and on terms described in one or more supplements to the prospectus that is included as part of the shelf registration statement.

Each time a BDC uses its prospectus to offer securities, it will provide a prospectus supplement that will contain specific information about the terms of that offering. A prospectus supplement may also add, update or change information contained in the base prospectus. The terms of any shelf offering are finalized at the time of the offering and disclosed in a prospectus supplement. BDCs may engage in sales immediately after effectiveness of the shelf registration statement if the offering-specific information is included as a part of the registration statement in a prospectus supplement filed under Rule 497 under the Securities Act.

BDCs typically use shelf registration statements to issue debt and equity securities. Debt securities are issued by BDCs from time to time either in “follow-on” offerings or “takedowns” from a medium-term note program (in which case a prospectus supplement for the medium-term note program is first filed with the SEC). BDCs also frequently list their debt securities on a national securities exchange (such debt securities are referred to as “baby bonds” due to their low minimum denominations). Equity securities are issued by BDCs from time to time either in follow-on offerings or in “at the-market” (“ATM”) offerings as described in more detail below.

In addition to the types of securities offerings mentioned above, a BDC may also issue rights that convert into voting securities even when its common stock is trading below NAV, subject to certain limitations. In a rights offering, a BDC’s existing shareholders receive the opportunity to purchase, on a pro rata basis, newly issued shares of the BDC’s common stock at an exercise price typically set at a significant discount to the market price of the common stock. A rights offering may be a useful way of raising capital while avoiding shareholder approval requirements. Rights offerings may be either transferable or non-transferable. A transferable rights offering permits the subsequent sale of such rights in the open market. The SEC has generally taken the position that no more than one additional share of common stock may be issued for each three shares of common stock currently outstanding in connection with a transferable rights offering below NAV. Due to the reduced dilution concern, non-transferable rights offerings are not subject to the same limitation.

ATM Offerings for BDCs

An ATM offering is an offering of securities into an existing trading market for outstanding shares of the same class at other than a fixed price (i) on, or through the facilities of, a national securities exchange, or (ii) to or through a market-maker. Therefore, the price at which securities are sold in an ATM offering will vary because it is based on the price of the securities in the trading market. An “equity distribution program” provides a means for a BDC to conduct ATM offerings from time to time using a shelf registration statement to or through a broker-dealer acting either on a principal or agency basis. Each ATM offering then is a “takedown” from the related shelf registration statement.

The BDC can either (i) use an allocated portion of an already existing universal shelf registration statement specifically for ATM offerings or (ii) prepare a new shelf registration statement specifically for ATM offerings. If the issuer decides to use an already existing shelf registration statement, then the BDC must prepare a prospectus supplement specifically for the equity distribution program. At the time the ATM offering commences, the BDC will file a prospectus supplement pursuant to Rule 497 under the Securities Act that discloses the terms of the offering, including the name of the sales agent. A post-effective amendment to the shelf registration statement will be filed with the equity distribution agreement entered into between the BDC and the sales agent. Post-effective amendments filed solely to add exhibits, such as the equity distribution agreement, become effective upon filing with the SEC. Note that for BDCs, the equity distribution agreement is subject to the requirements of Section 15(c) of the 1940 Act and must be approved at an in-person board meeting called for the purpose of voting on the agreement by a majority of the BDC’s directors who are not interested parties.

Shelf Offering NAV Determination

As noted above, a BDC is not generally able to issue and/or sell its common stock at a price below its NAV per share unless it has received prior approval from its shareholders. As a result, a BDC’s board of directors or an authorized committee thereof will be required to make a determination that the BDC is not selling shares of its common stock at a price below the then-current NAV at the time the sale is made. In the context of an offering of common stock under a shelf registration statement, the BDC’s board of directors typically considers the following factors, among others, in making its offering-specific NAV determination:

- the BDC’s NAV disclosed in its most recent periodic report that was filed with the SEC;
- management’s assessment of whether any material change in the BDC’s NAV has occurred (including through the realization of gains on the sale of its portfolio securities) during the period beginning on the date of the BDC’s most recently disclosed NAV and ending two days prior to the date of the sale of the BDC’s common stock; and
- the magnitude of the difference between (i) a value that the BDC’s board of directors has determined reflects the BDC’s current NAV, which is generally based upon the BDC’s NAV disclosed in the most recent periodic report that it filed with the SEC, as adjusted to reflect management’s assessment of any material change in the BDC’s NAV since the date of the BDC’s most recently disclosed NAV; and (ii) the current offering price of the BDC’s common stock.

Undertakings

Among other requirements, Form N-2 requires a BDC to undertake to:

- suspend any offering of shares of common stock until the prospectus is amended if (i) subsequent to the effective date of its registration statement, the BDC's NAV declines more than 10% from its NAV as of the effective date of the registration statement; or (ii) the BDC's NAV increases to an amount greater than the net proceeds as stated in the prospectus;
- file a post-effective amendment to the registration statement to include any prospectus required by Section 10(a)(3) of the Securities Act;
- file a post-effective amendment to the registration statement to reflect in the prospectus any facts or events after the effective date of the registration statement (or the most recent post-effective amendment thereof) that, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement;
- remove from registration by means of a post-effective amendment any of the securities being registered that remain unsold at the termination of the offering; and
- file a post-effective amendment to the registration statement in the event that the BDC's common stock is trading below its NAV and either (i) the BDC receives, or has been advised by its independent registered accounting firm that it will receive, an audit report reflecting substantial doubt regarding the BDC's ability to continue as a going concern; or (ii) the BDC has concluded that a material adverse change has occurred in its financial position or results of operations that has caused the financial statements and other disclosures in the registration statement, on the basis of which the offering would be made, to be materially misleading.

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