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It's Time To Loosen The Limitations On BDC Investors

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Business development companies, which provide a growing and important alternative source of capital to smaller companies, face challenges raising money due to a quirk in the federal securities laws that limits how much mutual funds can invest in them. But if BDCs, mutual funds, exchange-traded funds and other participants in the capital markets raise their voices, there is some hope that the U.S. Securities and Exchange Commission will ease the restriction so that BDCs can fulfill their statutory mission of raising capital for smaller companies that cannot otherwise find bank financing.

As investment companies, BDCs are subject to certain provisions of the Investment Company Act of 1940, including the limitations in Section 12(d)(1) of the 1940 Act. Among other things, this section limits the ability of other registered investment companies (including ETFs) to acquire more than 3 percent of a BDC's total outstanding stock. Given the relatively small size of many BDCs, this meaningfully restricts their ability to raise money from key institutional investors. Unfortunately, the trickle-down effect of this restriction limits the ability of BDCs to use their capital to provide small and middle-market businesses the ability to continue to develop and grow.

It may be time for the SEC — or its staff — to consider rulemaking or exemptive relief to address this limitation on the capital markets.

Background

BDCs are closed-end investment companies that have elected to be subject to the provisions of Sections 55 through 65 of the 1940 Act.[1] BDCs primarily invest in "eligible portfolio companies," which are domestic issuers that either (1) do not have any class of securities listed on a national securities exchange or (2) have a class of equity securities listed on a national securities exchange, but have an aggregate market value of less than $250 million. In recent years, BDCs have increasingly focused on mezzanine and debt investments that generate current income.

Many BDCs are listed on a national securities exchange. They therefore provide investors with the same liquidity as any other publicly traded security, but they are held and traded primarily by retail investors. Interestingly, many BDCs do not have a large institutional shareholder base. This may be attributable, at least in part, to the fact that Section 12(d)(1) of the 1940 Act limits the ability of registered investment companies, including ETFs, to hold more than 3 percent of the outstanding shares of another investment company, including a BDC. This restriction limits the ability of BDCs to raise meaningful amounts of

capital from a key participant in the institutional marketplace and, in turn, restricts the ability of BDCs to use that capital to invest in the small and middle-market companies that they serve, to the detriment of such companies, including small, startup businesses.

Policy Concerns

Prior to the enactment of the 1940 Act, individuals could acquire control of a fund and use its assets to acquire control of the assets of another fund, which, in turn, could use its assets to control a third fund. As a result, a few individuals effectively could control millions of dollars in shareholder assets invested in various acquired funds and could influence the investments in such funds for their benefit. Such structures also resulted in the duplication of fees, which were borne by investors. Section 12(d)(1) of the 1940 Act was precisely designed to limit the opportunity for such "pyramid" structures or investments in multiple funds.

In order to eliminate the opportunity for pyramid structures or investments, Section 12(d)(1)(A) prohibits a registered investment company from:

- acquiring more than 3 percent of another investment company's voting securities;
- investing more than 5 percent of its total assets in any one acquired investment company; or
- investing more than 10 percent of its total assets in all acquired investment companies.

Since BDCs are closed-end investment companies, the ability of registered investment companies — whether open-end or closed-end — to invest in BDCs is restricted by the provisions of Section 12(d)(1)(A).

Analysis

BDCs are inappropriately disadvantaged by the restrictions imposed by Section 12(d)(1)(A) on registered funds that seek to invest in BDCs in order to gain exposure to private companies in the small and middle markets. In particular, BDCs do not present the kind of policy concerns that the 3 percent ownership limit is designed to address because of the statutory and regulatory restrictions already imposed on a BDC's investment portfolio.

Under Section 55(a) of the 1940 Act, a BDC must generally have at least 70 percent of its total assets in the following investments:

- privately issued securities purchased from issuers that are eligible portfolio companies (or from certain affiliated persons);
- securities of eligible portfolio companies that are controlled by the BDC and of which an affiliated person of the BDC is a director (a controlling interest is presumed if the BDC owns more than 25 percent of a portfolio company's voting securities);
- privately issued securities of companies subject to a bankruptcy proceeding, reorganization, insolvency, or similar proceeding or otherwise unable to meet their obligations without material assistance;

- cash, cash items, government securities or high-quality debt securities maturing in one year or less; and
- office furniture and equipment, interests in real estate and leasehold improvements, and facilities maintained to conduct the business of the BDC.

BDCs are also required to offer eligible portfolio companies "significant managerial assistance," which may include operational and management advice or membership on the board of directors of a portfolio company. In other words, unlike most registered investment companies, BDCs are not passive investors. BDCs operate more like private equity investors. Moreover, Section 60 of the 1940 Act imposes the restrictions of Section 12 on BDCs to the same extent as though BDCs were registered closed-end investment companies. Accordingly, BDCs cannot have significant investments in other registered or unregistered investment companies.[2] In other words, the investment portfolio of a BDC is distinguishable from passive investments made by other investment companies, and the opportunity for pyramid structures or investments does not exist.[3]

BDCs could, however, provide an opportunity for registered funds to gain exposure to private companies in the small and middle markets, including small business investment companies, or SBICs, in the form of a registered security. BDCs are typically registered under the Securities Act of 1933, as amended, and are subject to all of the registration and reporting requirements of that statute and the Securities Exchange Act of 1934, as amended. BDCs also are often listed on an exchange and subject to the exchange's corporate governance requirements. More importantly, BDCs are closed-end investment companies and thus are subject to many of the restrictions and requirements of the 1940 Act. These include limitations on the ability to use leverage, routine reporting requirements, valuation obligations, and the oversight of a board of directors that includes members that are not "interested persons" (as defined in the 1940 Act) of the BDC or its adviser, if applicable. In addition, the board of directors of a BDC must approve, and the BDC must implement, a written compliance program reasonably designed to ensure compliance with the federal securities laws.

In short, acquiring more than 3 percent of the outstanding voting securities of a BDC does not seem to present the types of policy concerns that Section 12(d)(1)(A) was designed to address. Indeed, the SEC staff on more than one occasion has granted exemptive relief to enable registered funds operating as exchange-traded funds to invest in BDCs in excess of the 3 percent limitation.[4]

In granting such relief, the SEC staff has imposed conditions designed to address the public policy concerns of pyramid structures or investments, including oversight by the acquiring investment company's board of trustees, limitations on layering fees, adoption of policies regarding proxy voting, limitations on the ability to exercise control over an underlying BDC, and the requirement for the acquiring fund and the BDC to enter into participation agreements and provide records to monitor compliance with the provisions of the exemptive relief. These conditions could, however, be included in a general exemptive rule rather than requiring that investment companies bear the significant cost and the delay of seeking individual exemptive relief.

Conclusion

Over the last several years, recognizing that access to traditional forms of capital has become increasingly difficult, Congress has moved decisively to help small businesses more easily access the capital markets. The SEC could do its part by adopting a new exemptive rule under Section 12(d)(1)(A) to enable registered investment companies (including ETFs) to invest in BDCs in excess of the 3 percent

threshold. Alternatively, the SEC and the SEC staff could work with registrants to grant individual exemptive relief. In either event, BDCs stand ready to use that capital to provide small and middle-market businesses the ability to continue to develop and grow.

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[1] BDCs are subject to many, but not all, of the provisions of the 1940 Act. For more information regarding BDCs and their operations, see our "Frequently Asked Questions about Business Development Companies," available at: http://media.mofo.com/files/Uploads/Images/FAQ-Business-Development-Companies.pdf.

[2] BDCs may create wholly owned subsidiaries that operate as "small business investment companies" (SBICs), which rely on an exclusion from the definition of "investment company" under the 1940 Act.

[3] However, the staff of the Division of Investment Management of the SEC has granted no-action relief from Sections 2(a)(48) and 55(a) of the 1940 Act to enable a feeder fund to elect to be treated as a BDC notwithstanding the fact that the feeder fund's investment in the master fund would not be an investment in an eligible portfolio company and the feeder fund would not make significant managerial assistance available to the issuers of securities held by the master fund. Carey Credit Income Fund and Carey Credit Income Fund 2015 T, SEC No-Action Letter (July 15, 2015).

[4] See, e.g., In the matter of Global X Funds et al., Rel. No. IC-30454 (Apr. 9, 2013); In the matter of PowerShares Exchange-Traded Fund Trust et al.,Rel. No. 32035 (Mar. 22, 2016). As made applicable to BDCs by Section 60 of the 1940 Act, Section 12(d)(1)(C) of the 1940 Act limits the ability of any investment company (whether registered or not) to acquire more than 10 percent of the total outstanding voting stock of a BDC. However, the exemptive relief granted to date has also provided relief from this limitation.

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