SUTHERLAND

LEGAL ALERT

July 2, 2012

Congress Considering Legislation to Increase BDC and SBIC Access to Capital

Overview

Business Development Companies (BDCs) and Small Business Investment Companies (SBICs) are an increasingly important source of financing for privately held small and middle-market companies. As their importance has increased in recent years, BDCs have encountered regulatory hurdles that have stymied their ability to provide access to capital for businesses excluded from traditional sources of financing. Recently, members of Congress have introduced a pair of bills that would increase the amount of funds available for the BDC and SBIC industries to lend to small and middle-market companies. This Legal Alert examines these bills and their implications for BDCs, SBICs, and BDCs that operate SBIC subsidiaries.

On June 8, 2012, Representatives Michael M. Grimm (R-NY) and Nydia M. Velázquez (D-NY) introduced the Next Steps for Credit Availability Act (H.R. 5929) to reform certain aspects of the regulatory regime that governs BDCs. H.R. 5929 is currently in committee. In addition, on February 28, 2012, Sens. Mary L. Landrieu (D-LA) and Olympia J. Snowe (R-ME) introduced Senate Bill 2136 (S. 2136), which would expand the Small Business Administration's (the SBA) authorization to guarantee loans to SBICs. S. 2136 is also currently in committee.

The Next Steps for Credit Availability Act

H.R. 5929, in its current form, encourages BDC investment in small and middle-market businesses by improving BDCs' ability to raise capital. It would amend certain sections of the Investment Company Act of 1940 (the 1940 Act) and compel the Securities and Exchange Commission (the SEC) to amend certain of its rules under the Securities Act of 1933 (the 1933 Act). If enacted, the bipartisan bill would:

- Allow BDCs to own registered investment adviser subsidiaries without the need to obtain exemptive relief from the SEC to do so;
- Increase the amount of funds BDCs may borrow by reducing asset-to-debt coverage requirements from 2:1 to 1.5:1, exclude preferred stock from the asset-to-debt coverage requirements and allow BDCs to issue multiple classes of preferred stock;
- Permit BDCs to file SEC registration statements that incorporate information from already-filed reports by reference; and
- Use other streamlined registration processes afforded to operating companies.

BDC Ownership of Registered Investment Advisers

With limited exceptions, the 1940 Act and the rules thereunder currently prohibit BDCs and other investment companies from owning an interest in a registered investment adviser. Historically, BDCs owned unregistered investment advisers by relying on the so-called "private adviser exemption" from registration with the SEC under the Investment Advisers Act of 1940 (the Advisers Act) for investment advisers with fewer than 15 clients. The Dodd-Frank Wall Street Reform and Consumer Protection Act of

2010, however, removed the private adviser exemption, thereby requiring many previously unregistered investment advisers to register with the SEC or with a state securities regulator. Since then, several BDCs have sought and received exemptive relief to own registered investment advisers subject to certain conditions. Section 2 of H.R. 5929, if enacted, would allow all BDCs to own registered investment advisers without the need to obtain exemptive relief.

Measures to Improve the BDC Capital Structure

Asset Coverage Limit Reductions

H.R. 5929 would grant BDCs significantly more flexibility in arranging their capital structures. The 1940 Act limits a BDC's ability to use leverage by imposing asset coverage requirements for borrowings or "senior securities." Under these limits, a BDC cannot borrow or issue senior securities unless, immediately after the borrowing or issuance, the BDC's asset coverage ratio (*i.e.*, the ratio of total assets to debt) is 2:1. In other words, BDCs must hold $2 of assets for every $1 of debt. H.R. 5929 would reduce the asset coverage ratio applicable to BDCs from 2:1 to 1.5:1. Thus, BDCs would only be required to hold $1.50 of assets for every $1 of debt. This amendment would enhance BDCs' ability to use leverage to increase the breadth and depth of their investments and would make more capital available to small and middle-market companies through BDC investment.

Preferred Stock Issuance

H.R. 5929 would also give BDCs more latitude to offer preferred stock. Sections 18 and 61 of the 1940 Act currently place a number of restrictions on a BDC's ability to issue preferred stock, which, like debt, is considered to be a "senior security." In particular, a BDC cannot issue multiple classes of preferred stock, and it cannot issue preferred stock or pay a dividend or distribution on preferred stock if its asset coverage ratio would fall below 2:1 after the issue or payment. H.R. 5929 would permit BDCs to issue multiple classes of preferred stock and would exempt BDCs from the asset coverage ratios discussed above that are otherwise applicable to preferred stock issued by investment companies. This flexibility with regard to preferred stock would provide BDCs with access to additional capital to invest in small and middle-market companies.

Registration and Reporting Parity for BDCs

H.R. 5929 would modify the SEC registration and reporting process for BDCs. BDCs are subject to numerous registration and offering requirements that are not applicable to other 1933 Act and Securities Exchange Act of 1934 registrants of comparable size and vintage because the SEC's 2005 securities offering reform did not apply to BDCs. H.R. 5929, in effect, extends securities offering reform to BDCs and allows BDCs to rely on the more streamlined and flexible process and rules relied upon by other public companies since 2005 in connection with their registered offerings. Among other amendments, H.R. 5929 would compel the SEC to revise its registration and offering rules to:

- Allow BDCs to be eligible to be "well-known seasoned issuers," (WKSIs) so that they may take advantage of the streamlined registration requirements for WKSIs, including permitting automatically effective Form N-2 registration statements;
- Allow BDCs to file SEC registration statements that incorporate information from already-filed reports by reference; and,

- Permit BDCs to take advantage of several safe harbors and exemptions related to offerings to more openly communicate with their stockholders and potential investors in connection with registered offerings.

SBIC Enhancements

There have been several legislative initiatives to increase the amount of leverage available under the SBIC program to increase investment in small businesses. On February 2012, Landrieu, chair of the Senate Committee on Small Business and Entrepreneurship, introduced S. 2136, which authorizes the Administrator of the SBA to make $4 billion in guarantees of debentures of SBICs for programs under the Small Business Investment Act of 1958. This proposed legislation also amends the Small Business Investment Act of 1958 to increase the maximum amount of outstanding leverage to be made available by the SBA to two or more commonly controlled SBICs from $225 million to $350 million. If enacted, S. 2136 would provide additional financing to SBICs, including those that are structured as subsidiaries of BDCs.

More SBIC legislation may be on the horizon. Since the introduction of S. 2136, the House Committee on Small Business has held a series of hearings on the state of small business investment. The hearings have examined obstacles to small business growth and job creation, with a focus on access to capital for small businesses. As a result of these hearings, there may be additional legislation to provide SBICs with greater access to capital to invest in small businesses.

Sutherland has been working on behalf of the BDC industry for years to achieve similar changes, including providing comments to the SEC in 2005 when the SEC first introduced proposed offering reforms. We have summarized the provisions of the current House bill that would affect BDCs in the attached chart. Copies of both pending bills, Sutherland's comment letter, and other relevant information is also available at our practice site at www.publiclytradedprivateequity.com

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If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

Steven B. Boehm	202.383.0176	steven.boehm@sutherland.com
Cynthia M. Krus	202.383.0218	cynthia.krus@sutherland.com
John J. Mahon	202.383.0515	john.mahon@sutherland.com
Harry S. Pangas	202.383.0805	harry.pangas@sutherland.com

Summary of the Next Steps for Credit Availability Act	
Section, Rule or Form to Be Amended	**Impact on BDCs**
Ownership of Registered Investment Advisers	
1940 Act Section 60	Allows BDCs to own registered investment advisers.
Asset Coverage Limit Reductions	
1940 Act Sections 18 and 61(a)	Lowers the asset coverage requirement for BDCs from 2:1 to 1.5:1 and allows BDCs to issue multiple classes of preferred stock.
Registration and Reporting Parity	
Forward Incorporation (Form N-2)	Allows BDCs to incorporate already-filed information by reference.
WKSI Status (Rules 405 and 433)	Allows BDCs to: • qualify as WKSIs; • file automatic shelf registrations; and • use free-writing prospectuses.
Flexible Communications (Rules 168 and 169)	Permits BDCs to release factual and forward-looking business information.
Prospectus Safe Harbors (Rules 134, 163 and 163A)	Allows BDCs to communicate with investors more freely during the preparation and filing periods for a registration statement.
Research (Rules 138 and 139)	Allows broker-dealers and other providers of market research more flexibility to disseminate research on BDCs.
Free-Writing Prospectus Safe Harbor (Rule 164)	Provides a safe harbor to BDCs for post-filing free-writing prospectuses.
Shelf Registration (Rule 415)	Allows a BDC to file an N-2 shelf-registration statement for continuous or delayed offerings.
Final Prospectus (Rule 497)	Synchronizes BDC prospectus filing requirements with those of other registrants under Rule 424(b).
Written Confirmation (Rules 172 and 173)	Relieves BDCs of the requirement to provide written confirmations of sales, notifications of allocation, and deliveries of securities.