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Client Alert

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No-Action Relief Allows Business Development Companies to Hold Shares of Investment Advisers

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In two separate no-action letters, the SEC staff quietly expanded the ability of business development companies (BDCs) to invest in registered investment advisers.

Section 12(d)(3) of the Investment Company Act of 1940 generally prohibits registered investment companies from acquiring securities of issuers that are in the securities business. This prohibition extends to issuers that are broker-dealers and registered investment advisers and applies to closed end funds that elect to be treated as BDCs.

In each of the two no-action letters, a BDC proposed a corporate restructuring that, if consummated, would leave the BDC owning shares of a registered investment adviser. In each case, the staff provided assurances that it would not recommend enforcement action despite the prohibition in Section 12(d)(3).

The staff made it clear that it "does not express any legal conclusion or interpretive conclusion" on the issues presented. Rather, it provided limited assurances concerning enforcement, based on narrow facts.

The first letter involved a BDC organized in a master feeder structure. The "master fund" was an operating company that owned all of the portfolio investments and otherwise conducted all of the business of the master fund and its two feeder funds.

Each of the master fund and the two feeder funds had elected to be treated as BDCs under the 1940 Act. The master BDC proposed to form one or more private funds for which it would serve as the investment adviser, and it anticipated that it might be required to register as an investment adviser pursuant to Section 203 of the Investment Advisers Act. The master BDC was concerned that, if it registered, Section 12(d)(3) would prohibit a feeder BDC from holding its membership units.

The second letter involved an internally managed BDC that was registered as an investment adviser and served as a subadviser for an unaffiliated externally managed BDC. The internally managed BDC had elected to be treated as a regulated investment company (RIC) under the Internal Revenue Code. Income from investment advisory activities does not count as "good" income for purposes of meeting the RIC income test under the Code, so the BDC sought to transfer the sub-advisory agreement to its wholly owned subsidiary, which did not seek RIC status. However, if the subsidiary was required to be registered as an investment adviser, Section 12(d)(3) could preclude the internally managed BDC from owning securities of the subsidiary.

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In each no-action request, the BDCs argued that the proposed transactions did not raise the concerns underlying Section 12(d)(3) of the 1940 Act. "Congress adopted Section 12(d)(3) for two primary purposes: (a) to limit exposure of entrepreneurial risk associated with securities-related businesses; and (b) to mitigate any potential conflicts of interest, particularly in connection with reciprocal practices with a broker/dealer that may sell the investment company's shares." In particular, the BDCs argued that the concerns underlying the adoption of Section 12(d)(3) related to an investment company's ownership of a brokerage or underwriting business, not an investment advisory business.

The BDCs noted that Section 12(d)(3)(B) excludes from the general prohibition persons "primarily engaged in the business of underwriting and distributing securities issued by other persons, selling securities to customers, or any one or more of such or related activities, [if] the gross income of such person normally is derived principally from such business or related activities." They argued that "related activities" should be read to allow activities that a registered investment company could lawfully engage in, and therefore it should exclude wholly-owned subsidiaries that engaged only in investment advisory services.

In the first letter, the BDC acknowledged that the legislative history addressed an investment company that wholly owns a subsidiary, but said that in a master feeder structure, the master fund should be able to register as an investment adviser. In support of its request, the BDC noted that, by providing services through the master BDC, the feeder BDCs were limiting shareholder exposure to potential liability since the master BDC was organized as a limited liability company rather than a partnership. Moreover, the opportunity for conflicts of interest or reciprocal practices was mitigated since the three BDCs all have the same board of directors and the shareholders of the two feeder BDCs vote on a pass-through basis with respect to any matters involving the master BDC.

As noted in recent Congressional testimony in support of proposed legislation that would ease leverage restrictions on BDCs (see our recent blog post), BDCs play "an increasingly important role in financing underserved small and mid-sized U.S. companies." As BDCs become more prevalent, it is likely that we will continue to see new structures develop that can provide a BDC with additional forms of income (e.g., advisory fee income) while still allowing it to take advantage of pass-through RIC status under the Code. The staff's willingness to consider these developing structures may help BDCs continue to access the capital markets for the benefit not only of their own investors but also the underlying portfolio companies for which they are an important form of funding.

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