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Operating Business Development Companies: A Brief Overview

Business development companies ("BDCs") were created by Congress in 1980 to serve as closed-end, venture capital funds for retail investors by financing small to mid-sized U.S. private companies. Since about 2004, BDC formations have focused on private credit investments that generate attractive and steady yield distributions to BDC shareholders as well as private equity/VC investments. BDCs are now also able to invest in small-cap (less than $250 million in common outstanding) listed issuers. BDCs may offer better outcomes for portfolio managers than other types of registered closed-end funds because, among other things, BDCs can compensate their advisers with incentive fees, allow twice as much leverage with a 150% asset coverage ratio requirement, and can, with shareholder approval, sell additional BDC shares for less than net asset value per share.

BDC Structures. BDCs may be structured in a number of ways. A BDC may be externally managed, which allows its investment adviser to receive an asset-based management fee, an incentive fee based on income and an incentive fee based on net capital gains without having to screen for investors having qualified client status, which status is currently set at $1.1 million in investor assets under management and $2.2 million in net worth. A BDC may also be internally managed like an operating corporation and have a profit sharing program for its management.

Further, BDCs may be structured as Listed BDCs, Non-Traded BDCs and Private BDCs. Listed BDCs have their stock traded on a stock exchange. Non-Traded BDCs register their share offerings for retail sale under the Securities Act of 1933 (Securities Act) but do not list their shares for exchange trading. Private BDCs do not register their offerings under the Securities Act but instead sell shares in private placements.

Comparison of Listed, Non-traded and Private BDCs

	Listed BDCs	Non-Traded BDCs	Private BDCs
Investor Type	Anyone.	Only investors meeting state suitability requirements – minimum income and/or net worth (e.g., $70,000 income and $250,000 net worth) – depends on state where share sales occur.	Only accredited investors (higher than state income and net worth minimums). Regulation D, Rule 506(c) exempt offerings using general solicitation and advertising available for verified accredited investor offerings.

	Listed BDCs	Non-Traded BDCs	Private BDCs
Liquidity for Investors	Sell BDC shares at market prices anytime.	Sell when the BDC engages in periodic tender offers – usually quarterly or monthly.	Without a BDC share repurchase program, sell when the BDC goes public, sells portfolio, liquidates or another stated liquidity event.
Filing of SEC Registration Statement	Comprehensive Form N-2 registration statement.	Comprehensive Form N-2 registration statement.	Less detailed Form 10 (Exchange Act-only registration).

Regardless of categorization, all BDCs are public reporting companies under the Securities Exchange Act of 1934 (Exchange Act). BDCs file annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. BDCs have annual shareholder meetings and deliver proxy statements to shareholders that have been filed with, and are subject to review by, the SEC. BDC officers, directors and owners of 10% or more of its stock must publicly report their transactions in BDC stock on Forms 3, 4 and 5 under Section 16 of the Exchange Act.

BDC Investments. At least 70% of a BDCs investments must be eligible assets, which encompass eligible portfolio companies, privately issued securities in bankruptcy proceedings, cash and property needed to operate the BDC. Eligible portfolio companies generally are those U.S. companies without any publicly traded securities or certain listed small-cap companies. The BDC is required to offer significant managerial assistance to its eligible portfolio companies, which offer need not be accepted. If the offer of assistance is accepted, there a number of ways BDCs can satisfy this requirement (e.g., regular management consulting services, board seats, exercise a controlling interest, allow another co-investing BDC to provide the assistance, etc.).

BDC Capital Structures & Leverage. BDCs may issue common and preferred stock and more than one class of senior secured debt as well as warrants, options and rights. Continuously offered BDCs may issue multiple classes of common stock with SEC exemptive relief. A BDC must issue its common stock at least at its net asset value per share (NAV). Below NAV offerings are only allowed if the BDCs shareholders annually approve of such sales or the BDC is engaged in a rights offering.

Any debt or senior security issued by a BDC must meet a 200% asset coverage rate after application of proceeds (50% debt to total capital ratio). Since the Small Business Credit Availability Act of 2018, BDCs may elect to have a 150% asset coverage rate ($66^{2/3}$% debt to total capital ratio). With these asset coverage rates, BDCs can enjoy a debt to total capital ratio that is more favorable than the 300% asset coverage ratio ($33^{1/3}$% debt to total capital ratio) allowed for registered closed-end funds.

Affiliate Transaction Restrictions. BDCs have greater latitude than registered closed-end funds to permit so-called "second tier affiliate" transactions solely with board approval. Second tier affiliates are (1) any 5% shareholder, (2) affiliates of a 5% shareholder, and (3) any affiliated person of a director, officer or employee, investment adviser, principal underwriter for or general partner in, or any person, controlling or under common control with, the BDC.

First tier affiliates are (1) any BDC director, officer or employee, (2) any entity such person controls, and (3) the BDC's adviser, underwriter, promoter or GP or any person that controls or is under common control (25%) with any of them or is an officer, director, partner or employee of any of them. An affiliate transaction involving the BDC and a first tier affiliate must receive approval from the SEC.

Tax Compliance. Most BDCs elect to be treated as regulated investment companies (RICs) for U.S. tax purposes allowing BDCs to be treated as pass-through entities that issue Form 1099s to their shareholders. As with other registered funds, BDC RIC status means that the BDC must, among other things, distribute substantially all of its taxable income annually, meet asset diversification tests and have at least 90% of its gross income coming from "good" sources (i.e., from securities investments).