Client Alert

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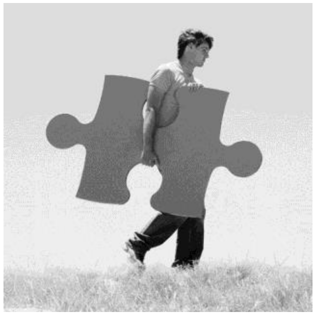

House Passes Regulatory Reform That Would Loosen Restrictions on BDCs and Other Funds

On June 8, 2017, the U.S. House of Representatives, by a vote mostly along party lines, approved a bill that would repeal many of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") requirements and significantly reduce the regulatory burden for financial institutions. If enacted in its current form, the Financial CHOICE Act of 2017 (the "CHOICE Act") would also alter the regulatory landscape for business development companies ("BDCs"), investment companies and investment advisers. Among other things, the CHOICE Act would:

- Loosen some restrictions on BDCs concerning leverage, preferred stock, proxy procedures and investments;
- Tighten the burden of proof for plaintiffs suing investment advisers for breach of fiduciary duty;
- Broaden the exemption from the definition of an "investment company" available to venture capital funds; and
- Streamline the process for investment companies and investment advisers to obtain exemptive orders.

The CHOICE Act, which passed 233-186, was sent to the Senate for consideration on June 12, 2017. Here is a summary of key provisions of the CHOICE Act that affect BDCs, investment companies and investment advisers.

A. BDCs

BDC investment in investment advisers. Section 436(a)(2) of the bill would eliminate a restriction in Section 12(d)(3) of the Investment Company Act of 1940, as amended (the "1940 Act') that prohibits a BDC from owning an equity interest in a registered investment adviser. Among other things, this provision would allow BDCs to invest in investment advisers to other investment companies, or to invest in its own investment adviser. (Section 12(d)(3) of the 1940 Act applies to BDCs by virtue of Section 60.) The bill also clarifies that the Securities and Exchange Commission ("SEC") has the power to issue rules to address potential conflicts of interest arising out of the ability of BDCs to invest in investment advisers.

Expanded definition of "eligible portfolio company." Section 436(b) would expand the definition of "eligible portfolio company" ("EPC"). A BDC currently must invest at least 70 percent of its total assets (excluding office furniture and equipment, real estate and leasehold improvements and certain operational facilities) in EPCs. An EPC is a domestic issuer that either:

- Does not have any class of securities listed on a national securities exchange, or
- Has a class of equity securities listed on a national securities exchange, but has an aggregate market value of outstanding voting and non-voting common equity of less than $250 million and, in each case:

(A) is not, with limited exceptions, a registered or unregistered investment company; or

(B) either:

(i) does not have a class of securities that are "margin securities,"

(ii) is controlled by a BDC and has an affiliated person of the BDC as a director or

(iii) has total assets of not more than $4 million and capital and surplus (shareholders' equity less retained earnings) of not less than $2 million.

The bill would expand the definition of EPC to include issuers that would be investment companies but for the following exemptions under Section 3 of the 1940 Act:

- 3(c)(2) – persons that are primarily engaged in the business of underwriting and distributing securities;
- 3(c)(3) – banks and insurance companies;
- 3(c)(4) – persons substantially all of whose business is confined to making small loans, industrial banking or similar businesses;
- 3(c)(5) – persons who are not engaged in the business of issuing redeemable securities or face amount certificates or period payment plans and who are primarily engaged in one or more of the following businesses:
  - Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable and other obligations representing part or all of the sales price of merchandise, insurance and services;
  - Making loans to manufacturers, wholesalers and retailers of, and to prospective purchasers of, specified merchandise, insurance and services; and
  - Purchasing or otherwise acquiring mortgages and other liens on and interests in real estate; and
- 3(c)(9) – persons substantially all of whose business consists of owning or holding oil, gas or other mineral royalties or leases and certain related interests.

The effect of this provision, if adopted, would be to broaden the categories of unregistered investment companies, including real estate funds and oil and gas funds, in which BDCs may invest.

Fifty percent requirement for EPC investments. Section 436(c) of the bill would lower to 50 percent (from 70 percent) the amount of which a BDC may invest its total assets (excluding certain assets described above in EPCs. This provision would effective increase a BDC's unrestricted investment bucket to 50 percent from 30 percent, giving it much more investment flexibility.

BDC leverage. Section 437 of the CHOICE Act would increase the amount of leverage that BDCs may use by lowering the asset coverage requirement to 150 percent from 200 percent under certain circumstances. Section 61(a) of the 1940 Act applies the 200 percent leverage limitation of Section 18(a)(1)(A) and (B) BDCs.

Section 437 would lower the asset coverage requirement to 150 percent, provided that:

- The BDC amends its public disclosures in securities filings and its website within five days of adopting the new standard;
- A publicly traded BDC must include disclosures "reasonably designed to ensure shareholders" are informed of (i) the amount of the BDC's indebtedness and asset coverage ratio as of recent financial statements and (ii) the risks associated with the indebtedness;
- A "required majority" of independent directors approve the new asset coverage level;

- For non-traded BDCs, the BDC must agree to repurchase 25 percent of its shares in each of the four quarters following the approval date; and
- At least 50 percent of the votes cast at a shareholder meeting approve the new standard.

Preferred stock. Section 437(a)(3) would authorize BDCs to issue preferred stock. Currently, BDCs can issue "more than one class of senior security representing indebtedness," or multiple debt obligations.

Warrants, options and subscription rights. Section 437(a)(4) would expand the ability of a BDC to issue warrants, options and subscription rights to any security, provided the exercise or conversion price is less than the market value of the securities to be issued, or in the absence of a market value, the net asset value of the securities to be issued. Currently, a BDC may issue these rights only with respect to voting securities.

BDC's senior securities. Section 437(a)(5) would eliminate provisions that generally:

- Require a BDC to allow holders of senior securities, voting as a class, to have the right to elect two directors;
- Require a BDC to allow a majority of preferred equity securities to vote on a plan of reorganization that adversely affects their securities;
- Require a BDC to provide for a senior security to have "complete priority" over any other class of distribution of assets and payment of cumulative dividends; and
- Limit the ability of a BDC to issue more than one class of indebtedness or stock.

These exclusions would not apply to holders of a BDC's preferred stock who are not "qualified institutional buyers." Under Section 437(a)(5)(B) of the CHOICE Act, Section 61(a)(3)(A) of the 1940 Act would no longer apply with respect to preferred stock issued to a person who is not known by the company to be a qualified institutional buyer.

Parity for BDCs regarding offering and proxy rules. Section 438 requires the SEC to revise its rules to allow BDCs to avail themselves of securities offering related accommodations and proxy rules available to other issuers that file reports under Section 13 or Section 15(d) of the Securities Exchange Act of 1934. The provision includes a laundry list of specific actions that the SEC must take.

Section 438(b) would also require the SEC to revise Form N-2, the form of registration statement, to allow BDCs to incorporate certain information by reference to other filings.

Section 438(c) entitles BDCs to treat these revisions in Sections 438(a) and (b) described above as having been completed if the SEC fails to timely complete these revisions within one year of the date of enactment of the CHOICE Act.

B. Investment companies (and BDCs)

Burden of proof requirements for excessive fee cases brought under Section 36(b). Section 831 of the CHOICE Act would revise Section 36(b) of the 1940 Act to impose a higher burden of proof for a plaintiff to successfully claim that an investment adviser to an investment company or BDC has breached its fiduciary duty with respect to its receipt of fees.

The provision would require a complaint to state with particularity all facts establishing a breach of fiduciary duty, and, if an allegation of any such facts is based on information and belief, the complaint shall state with particularity all facts on which that belief is formed; and such security holder would have the burden of proving a breach of fiduciary duty by clear and convincing evidence.

Exemptive applications. Section 848 would streamline the application process for SEC exemptive orders by imposing specific time deadlines. Specifically, the provision would require the SEC to grant or deny an application within 45 days after filing, or require the applicant to either provide additional supporting documentation or withdraw the application and resubmit it with additional required material.

C. Exemption from the definition of investment company

Venture capital funds. Section 471 would allow a "qualified venture capital fund" to rely on the exception from the definition of investment company provided by Section 3(c)(1) if its outstanding securities are beneficially owned by fewer than 500 persons. Currently, all issuers relying on Section 3(c)(1) can have more than 100 beneficial owners (subject to certain look-through provisions and other requirements). The provision would define a qualifying venture capital fund as any venture capital fund (as defined pursuant to Section 203(l)(1) of the Investment Advisers Act of 1940, as amended) with no more than $50,000,000 in aggregate capital contributions and uncalled committed capital, as such dollar amount is annually adjusted by the SEC to reflect the change in the Consumer Price Index for All Urban Consumers published by the Bureau of Labor Statistics of the Department of Labor.

D. Other provisions

The CHOICE Act would significantly modify or repeal many aspects of Dodd-Frank. This memorandum addresses only the main provisions that affect investment advisers, investment companies and BDCs. The other provisions are beyond the scope of this memorandum.

Our take

The CHOICE Act's BDC provisions would significantly loosen many of the restrictions that currently apply to BDCs and, if adopted, would make BDCs much more attractive investment vehicles. It remains to be seen how these changes would affect the market for pooled vehicles, and whether BDC assets would grow significantly at the expense of mutual funds and other closed end funds. The provisions designed to tighten the burden of proof for excessive fee cases were presumably added in response to the increasing number of cases brought under Section 36(b), notwithstanding the fact that few, if any, plaintiffs succeed at trial. Tightening the burden of proof may discourage plaintiffs from filing these cases, which are very costly to try and are generally directed at "deep pocket" fund complexes in hopes of a settlement.

The chances of the Senate passing the CHOICE Act as proposed are not certain at this time; however, many of the provisions of the CHOICE Act that are applicable to BDCs have been the subject of standalone bills that met with some bipartisan support.

MORRISON | FOERSTER

Authors

Jay G. Baris
New York
(212) 468-8053
jbaris@mofo.com

Julianne Nguyen
New York
(212) 336-4260
juliannenguyen@mofo.com

Contacts

Jay G. Baris
New York
(212) 468-8053
jbaris@mofo.com

Oliver Ireland
Washington D.C.
(202) 778-1614
oireland@mofo.com

Anna Pinedo
New York
(212) 468-8179
apinedo@mofo.com

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