Top 10 Practice Tips: Business Development Companies

A Practical Guidance® Practice Note by Nicole M. Runyan, William J. Tuttle and David J. Marcinkus, Proskauer Rose LLP

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Over the last several years, an increasing number of asset managers have evaluated the potential benefits of including a business development company (BDC) as part of a diversified credit platform. A BDC is a hybrid of an investment company and a traditional operating company, and, as a result, its capital-raising activities and operations are subject to a unique and complex adaption of various federal securities laws. Below are 10 practice tips that will help you navigate the BDC space without panicking.

For additional information on BDCs, see Business Development Companies.

1. **Origins.** BDCs were established under the Small Business Investment Incentive Act of 1980 as a type of closed-end investment company designed to provide capital to small, developing, or financially troubled U.S. companies that otherwise might have difficulty accessing the public capital markets. Congress also believed that these types of companies could potentially benefit from the BDC sponsor's financial and operational management expertise. BDCs elect pursuant to Section 54 (15 U.S.C. § 80a-53) of the Investment Company Act of 1940, as amended (1940 Act), to be subject to Sections 55 through 65 (15 U.S.C. §§ 80a-54 through 80a-64) and certain other provisions of the 1940 Act. In addition, BDCs are subject to the reporting requirements of the Securities Exchange Act of 1934, as amended, and file Forms 10-K, 10-Q, and 8-K with the Securities and Exchange Commission (SEC). Prior to 2003, the largest BDCs were internally managed, meaning that the BDC manages its assets through its own employees who are compensated directly by the BDC. Since that time, however, almost all new BDCs have been externally managed, meaning that the BDC engages an investment adviser registered under the Investment Advisers Act of 1940, as amended (Advisers Act), to manage its assets under the supervision of the BDC's board of directors. This has allowed a number of large asset managers to offer a BDC to their clients as part of a wide array of products across a number of strategies. Asset managers considering entry into the BDC space should give careful consideration to the proposed investment strategy and how a BDC will fit within the existing platform (including with respect to legal, operational, and other resources necessary to ensure compliance with regulatory restrictions).

2. **Listing.** The common stock of BDCs can be listed on a national securities exchange (e.g., The Nasdaq

Stock Market or the New York Stock Exchange), often in connection with an initial public offering (IPO) although a direct listing of the common stock is also possible where the BDC's stockholder base satisfies the relevant listing standards. In addition, there are a number of BDCs that have been offered to institutional investors (commonly referred to as "private BDCs") or through certain retail channels (often referred to as "continuously offered BDCs"), in each case that are not listed. Private BDCs typically offer and sell their common stock in transactions exempt from, or not subject to, the registration requirements under the Securities Act of 1933, as amended (Securities Act) (i.e., to accredited investors pursuant to Regulation D under the Securities Act or to "non-U.S. persons" pursuant to Regulation S under the Securities Act). By contrast, continuously offered BDCs typically sell their common stock pursuant to registration statements filed with and declared effective by the SEC, which allows access to certain retail investors. However, because their common stock is not listed on a national securities exchange, continuously offered BDCs are not able to take advantage of federal preemption under Section 18 of the Securities Act (15 U.S.C. § 77r) and therefore must qualify their common stock for offer and sale in each of the several states (also known as a blue sky qualification process). Although continuously offered BDCs had fallen out of favor, there have been some new entrants in the market over the last year, as the SEC started granting exemptive relief to BDCs to issue multiple share classes with varying sales loads and asset-based service and/or distribution fees. This "multi-class" relief has long been granted to continuously offered closed-end funds, such as interval funds, and with its expansion to BDCs, sponsors may want to re-assess the attractiveness of these products in the retail market.

3. **Eligible portfolio companies.** Consistent with Congressional intent that BDCs provide capital to small, developing or financially troubled U.S. companies, a BDC generally is prohibited from acquiring assets other than qualifying assets unless, after giving effect to any acquisition, at least 70% of its total assets are qualifying assets. Qualifying assets generally include securities of eligible portfolio companies, cash, cash equivalents, U.S. government securities, and high-quality debt instruments maturing in one year or less from the time of investment. As a general matter, a company is an eligible portfolio company if it: (1) is organized under the laws of any U.S. state and has its principal place of business in the United States; (2) is not an investment company or a company that would be an investment company except for the exclusions under Section 3(c) of the 1940 Act (15 U.S.C. § 80a-3); and (3) either (a) does not have any class of securities listed on a national securities exchange or (b) has an aggregate market value of its voting and non-voting equity securities of less than $250 million. Subject to certain limitations on investing in securities and insurance-related businesses, the remaining 30% of a BDC's total assets can be invested opportunistically, including in non-U.S. issuers, joint ventures, aircraft finance businesses, and unsecured consumer loans. Asset managers should ensure that they expect to have access to an appropriate level of qualifying assets following the launch of a BDC.

4. **Fee structure.** Externally managed BDCs typically pay their investment advisers a base management fee and an incentive fee, although the rates can vary meaningfully depending on the BDC's investment strategy, the year in which the BDC was launched, and whether the BDC's common stock is listed or unlisted. Fee structures are often a significant negotiation point at the time of a BDC's formation or an IPO as management and any underwriters review and assess market comparables. Fee structures have changed over the past several years, and managers considering establishing a BDC, or taking a private BDC public, should be certain to evaluate fee arrangements within the current market.

   Depending on the BDC structure and investment strategy, the base management fee is typically paid at an annual rate of between 0.75% and 2.0% of gross assets (often calculated excluding cash and cash equivalents) and is generally paid quarterly in arrears. The incentive fee typically has two parts: one based on the BDC's income and the other based on capital gains. The income-based component of the incentive fee is typically between 10.0% and 20.0% of the BDC's net investment income (calculated before payment of the incentive fee) over a specified annual rate of return (hurdle) of generally between 6.0% and 8.0% and often is paid quarterly in arrears. The capital gains component of the incentive fee is typically between 10.0% and 20.0% of a BDC's realized gains over a period less its realized losses and unrealized capital depreciation over the same period and is paid annually. The capital gains component of the incentive fee is subject to a statutory cap of 20.0% of realized gains less realized losses and unrealized capital depreciation. By contrast, the base management fee and the income-based component of the incentive fee are not subject to any statutory maximum.

Over the past several years, a number of BDCs have incorporated caps on their incentive fees such that they are not payable to the investment adviser absent certain returns to stockholders, which may be tied to rolling periods of time (often three years). In addition, many BDCs have incorporated limitations on the income-based component of the incentive fee such that it is payable only on amounts received by the BDC in cash. Asset managers should carefully consider market trends in BDC fee structures as well as fees across other investment vehicles they offer in connection with fixing the fee structure for any new BDC, especially as the asset manager will be limited in its ability to adjust the fee structure without approval of the BDC's stockholders.

5. **Approval of investment advisory agreements.** The initial investment advisory agreement between a BDC and its investment adviser may have a term of no more than two years from its date of execution and must be approved by: (1) a majority of the BDC's board of directors; (2) a majority of the directors who are not interested persons (within the meaning of the 1940 Act) of the BDC (at an in-person meeting called for that purpose); and (3) the holders of a majority of the outstanding voting securities of the BDC (which means the affirmative vote of the lesser of (a) 67% or more of the voting securities of the BDC present or represented by proxy at a stockholder meeting, if the holders of more than 50% of the outstanding voting securities are present or represented by proxy at such meeting, or (b) more than 50% of the outstanding voting securities). The initial stockholder approval is typically accomplished before the BDC accepts money from outside investors. However, any subsequent modification to the investment advisory agreement (other than fee reductions) will generally require that the BDC seek stockholder approval of such modification.

   Following its initial term, the investment advisory agreement will remain in effect from year to year thereafter if approved annually by the BDC's board of directors or by the affirmative vote of the holders of a majority of outstanding voting securities of the BDC, and, in either case, a majority of the directors who are not interested persons of the BDC (at an in-person meeting called for that purpose).

   In connection with their consideration of the investment advisory agreement, the directors of the BDC must request and evaluate (and the BDC's investment adviser must provide) such information as may reasonably be necessary to evaluate the terms of the investment advisory agreement. The resulting analysis should focus on a number of items, including: (1) the nature, extent, and quality of services performed by the investment adviser; (2) the investment performance of the BDC and the investment adviser; (3) the costs of providing services to the BDC; (4) the profitability of the relationship between the BDC and its investment adviser, including realized and potential economies of scale; and (5) comparative information on fees and expenses borne by other comparable BDCs or registered investment companies and other advised accounts. No single factor in this analysis is required to be dispositive.

   Given the technical nature of the requirements for the approval of an investment advisory agreement and the amount of information provided to directors as part of the approval process, asset managers should carefully set the fee structure such that amendments will not be required except in extreme circumstances and should consider the timings of required approvals and plan accordingly.

   In connection with the circumstances related to COVID-19, the SEC has granted conditional relief from the in-person voting requirements described above. Relief from the in-person requirement was initially set to expire on December 31, 2020; however, on January 5, 2021, the SEC extended the relief indefinitely, indicating that it will give at least two weeks' prior notice before terminating the relief. (See An Update on the Commission's Targeted Regulatory Relief to Assist Market Participants Affected by COVID-19 and Ensure the Orderly Function of our Markets.) BDCs should consult with their legal counsel regarding the conditions associated with this relief.

6. **Termination of investment advisory agreements; Section 15(f).** The 1940 Act requires that the holders of a majority of the outstanding voting securities of a BDC be able to terminate the investment advisory agreement at any time without penalty upon not more than 60 days' written notice to the investment adviser. In addition, the investment advisory agreement must provide that it terminates automatically in the event of its assignment. For purposes of the 1940 Act, the acquisition by any person of greater than 25% of the voting securities in an investment adviser will generally constitute an assignment, as will the failure of any greater than 25% holder to continue holding greater than 25% of the voting securities of the investment adviser. As a result, a change of control transaction of the investment adviser to a BDC will generally require that the BDC seek stockholder approval of the

investment advisory agreement, regardless of whether economic terms are changing.

As a general matter, Section 15(f) of the 1940 Act (15 U.S.C. § 80a-15) prohibits an investment adviser from receiving compensation or other benefit in connection with the sale of an interest in the investment adviser that results in an assignment unless (1) during the three-year period following the consummation of a transaction, at least 75% of the BDC's board of directors must not be interested persons of the new investment adviser or predecessor adviser, and (2) an unfair burden must not be imposed on the BDC as a result of the transaction relating to the sale of such interest, or any of its applicable express or implied terms, conditions, or understandings. The term unfair burden includes any arrangement, during the two-year period after the transaction, whereby the investment adviser (or predecessor or successor adviser), or any interested person of such an investment adviser, receives or is entitled to receive any compensation, directly or indirectly, from the BDC or its stockholders (other than certain advisory and services fees) or from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of the BDC (other than certain underwriting compensation).

Asset managers evaluating change of control transactions should take care to ensure that no party inadvertently takes action that would result in the assignment of an investment advisory agreement prior to receipt of appropriate stockholder approvals and should also address as part of the transaction documentation appropriate allocation of responsibility for ensuring compliance with Section 15(f).

7. **Co-investment.** The 1940 Act prohibits a BDC from knowingly participating in certain types of transactions with its affiliates without prior approval of a required majority of its directors (as defined in the 1940 Act) and, in some cases, prior approval by the SEC. These restrictions generally prohibit a BDC from engaging in joint transactions with other entities that share the same investment adviser (or an investment adviser controlling, controlled by, or under common control with such adviser). Certain types of co-investments across a platform of affiliated funds, including a BDC, could constitute such a prohibited joint transaction. The staff of the SEC has granted no-action relief permitting purchases of a single class of privately placed securities provided that the investment adviser negotiates no term other than price and certain other conditions are met. However, many BDCs and their investment advisers seek exemptive orders from the SEC to permit greater flexibility to negotiate the terms of co-investments. Under the terms of this relief, a required majority of the BDC's board of directors would be required to make certain findings in connection with any negotiated co-investment transaction, including that the terms of the proposed transaction do not involve overreaching of the BDC by the investment adviser or its affiliates and that the transaction is consistent with the BDC's investment strategies and policies. Asset managers should consider whether the strategy for their BDC overlaps with that of other funds and accounts and, if so, whether the ability to co-invest on originated or other negotiated transactions is important to the successful implementation of the investment strategy across relevant accounts. In July 2020, the SEC adopted rules expediting the exemptive relief process under the 1940 Act. Those rules became effective in June 2021. Asset managers considering the need for, and type of, co-investment relief should discuss with counsel whether such relief could be available on an expedited basis or whether standard review by the SEC staff will be required.

8. **Use of leverage.** The 1940 Act contains asset coverage requirements which limit the ability of BDCs to incur leverage. Since March 2018 BDCs have been able to increase the maximum amount of leverage that they are permitted to incur, so long as the BDC meets certain disclosure requirements and obtains certain approvals. Under these modified asset coverage requirements, a qualifying BDC may incur additional leverage, as the asset coverage requirements for senior securities applicable to the company pursuant to Sections 18 (15 U.S.C. § 80a-18) and 61 (15 U.S.C. § 80a-60) of the 1940 Act are reduced to 150% (equivalent to a 66-2/3% debt-to-total capital ratio, i.e., a 2:1 leverage ratio). For purposes of the 1940 Act, asset coverage means the ratio of (1) the total assets of a BDC, less all liabilities and indebtedness not represented by senior securities, to (2) the aggregate amount of senior securities representing indebtedness (plus, in the case of senior securities represented by preferred stock, the aggregate involuntary liquidation preference of such preferred stock). In order for a BDC to utilize a 150% asset coverage ratio, and thus be permitted to incur additional leverage, it must first obtain approval by either (1) a required majority of such BDC's board of directors (in which case the lower asset coverage ratio does not take effect until one year after the date of such approval) or (2) a majority of votes cast at a meeting of such BDC's stockholders at which a quorum

is present (in which case the lower asset coverage ratio becomes effective the next day). In addition, a BDC that does not have its common stock listed on a national securities exchange must offer each stockholder of record on the approval date of the reduced asset coverage requirements the opportunity for the BDC to repurchase such stockholder's securities held on such date. The BDC then must repurchase, by tender offer or otherwise, 25% of the securities held by electing stockholders of record on the approval date in each of the four succeeding calendar quarters following the quarter during which the reduced asset coverage ratio was approved, although a BDC may execute these repurchases on a more expedited timeline subject to certain conditions. Often, stockholder approval for the reduced asset coverage requirements is obtained before the BDC accepts money from outside investors.

BDCs can incur leverage through a variety of means, including traditional senior secured credit facilities, collateralized loan obligations, warehouse credit facilities, institutional notes offerings, retail (baby bond) notes offerings, debentures from the Small Business Administration, and preferred stock. Many BDCs have established both debt facilities that provide for revolving borrowings at a floating rate above LIBOR (or an equivalent) and debt facilities (or issued notes) that provide for term borrowings at a fixed rate.

Asset managers entering the BDC space should consider carefully the desired asset coverage requirement to which the BDC will be subject and also evaluate the types of leverage that fit best with the intended investment strategy.

9. **Compliance function.** BDCs are required to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws by the BDC, including policies and procedures that provide for the oversight of compliance by the BDC's investment adviser, administrator, transfer agent, and any principal underwriters. These policies and procedures are required to be approved by the BDC's board of directors on a finding that the policies and procedures are reasonably designed to prevent violations of the federal securities laws. Adequacy of the policies and procedures must be reviewed at least annually. BDCs are also required to have a chief compliance officer, whose designation and compensation are approved by the BDC's board of directors, including a majority of the directors who are not interested persons. This individual must deliver, no less than annually, a written report to the board of directors addressing the operation of the compliance program and any material compliance matters and meet in executive session with the directors who are not interested persons, also no less frequently than annually. In addition, the BDC's investment adviser must comply with provisions under the Advisers Act that require it to maintain its own compliance manuals and policies.

   Asset managers entering the BDC space should ensure that the existing compliance team has sufficient bandwidth for the new product or whether additional resources (whether at the asset manager or through retention of a third party) will be necessary.

10. **Consolidation and M&A transactions.** As the BDC industry has grown and BDCs have become an increasingly attractive vehicle for asset managers, the industry has experienced a number of novel consolidation transactions. Consolidation transactions could be an attractive and efficient way for asset managers to gain access to the BDC market whether through acquiring another asset manager (or the books and records related to managing a BDC), which may be an ideal option as certain asset managers evaluate succession planning or purchasing the investment advisory contract directly from the stockholders. In addition, existing BDCs may be able to gain scale through the acquisition of BDCs managed by other asset managers (e.g., Portman Ridge Finance Corporation's acquisitions of Garrison Capital Inc. and Capitala Finance Corporation) and/or through the consolidation of multiple BDCs across the same platform (e.g., recent consolidations of private BDCs managed by Golub Capital and Goldman Sachs into their affiliated publicly traded BDCs). Finally, some private BDCs have acquired a publicly listed BDC to effect a listing and provide liquidity to investors (e.g., Crescent Capital BDC's acquisition of Alcentra Capital Corp.). Any of these structures require careful analysis of a number of difficult issues ranging from 1940 Act restrictions to tax planning to corporate and securities laws. Asset managers evaluating the BDC space should consider whether a consolidation or M&A transaction might be a more efficient means of gaining access to capital, as compared to raising capital in a newly formed BDC or otherwise acquiring the resources to expand its platform.

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Nicole M. Runyan is a partner in the Corporate Department at Proskauer Rose LLP and counsels registered investment companies and their independent board members, as well as asset managers, across a wide range of regulatory, transactional and compliance matters.

Nicole advises on the creation, registration and operation of new and existing registered investment companies designed for institutional or retail investors, focusing on alternative investment products and strategies such as business development companies (BDCs), interval funds, funds-of-funds, private equity, private credit/direct lending, real estate, managed futures and other liquid alternative investments. Her experience covers the full range of issues facing funds, their boards and advisers, including regulatory and compliance matters, distribution (firm commitment and best efforts offerings for exchange-listed and non-listed funds), marketing and advertising, trading and conflicts issues, disclosure matters, valuation, financing transactions, SEC exemptive, no-action and similar regulatory relief, shareholder activism, and extraordinary events such as mergers, acquisitions, fund adoptions, liquidations and other restructurings.

Co-chair of the Women's Investment Management Forum, a networking and educational organization for women in the investment management industry, Nicole is active in the industry and publishes articles on topics of current interest, including new SEC regulations. She has been regularly recognized for her work in legal directories such as *Chambers USA*, *The Legal 500 United States* and the *IFLR1000*.

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During his nine-year tenure at the SEC, Dave was involved in nearly every significant, novel or complex matter affecting BDCs, and he regularly represented the Division at external conferences. In particular, Dave has extensive experience with affiliated transaction issues, often being consulted by Exams (formerly OCIE) on such matters. Dave has been at the forefront of BDC co-investment issues, and was one of the primary drafters of the FS model co-investment application. Dave also worked on the 2020 offering reform rulemaking, including the provision of technical assistance to Congressional staff.

Also while on the SEC staff, Dave was a member of the rulemaking team for 2020's long-awaited fair value rule 2a-5.

Prior to joining the SEC, Dave was in-house legal counsel at Lazard Asset Management.