

Publicly Traded Private Equity Review provides a periodic update of issues in the publicly traded private equity space.

Publicly Traded Private Equity Review

NOVEMBER 2008

VOL. 1, NO. 3

In This Issue

**BDC White Paper Requests
Regulatory Actions: Eliminating
Regulatory Barriers to Capital
Access for BDCs**

**The Non-Listed Structure: An
Alternative for BDCs**

**SEC Announces Global
Settlement With Eight Former
BDCs**

BDC White Paper Requests Regulatory Actions: Eliminating Regulatory Barriers to Capital Access for BDCs

On November 14, we prepared a White Paper for the staff of the Securities and Exchange Commission (“SEC”) and Capitol Hill to request certain regulatory actions to help Business Development Companies (“BDCs”) navigate the current credit crisis. As you know, in the present unprecedented credit squeeze, it has been difficult for financing companies, including BDCs, to access the capital markets. In the White Paper, we advocate for three important securities law changes that would allow BDCs greater flexibility to access capital. These suggested changes involve (1) the issuance of preferred stock; (2) raising capital at less than net asset value (“NAV”); and (3) the use of amortized cost for valuation.

Issuance of Preferred Stock

The BDC industry believes that it has a substantial opportunity to raise capital through strategic offerings of preferred stock if the restrictions imposed under the Investment Company Act of 1940 (the “1940 Act”) on its use—most notably the asset coverage requirement—are relaxed. Currently, under the 1940 Act, BDCs cannot borrow or issue preferred stock unless, following the transaction, they satisfy a 200% “asset coverage ratio” requirement. In addition, a number of other conditions are placed on the issuance of preferred stock, including limitations on the ability of a BDC to declare dividends on common stock if the asset coverage requirement is not met and a requirement that holders of preferred stock elect at least two members of the board.

The White Paper seeks the relaxation, at least on a temporary basis, of the obstacles that discourage BDCs from issuing preferred stock, either through legislation or administrative action. The White Paper argues that, consistent with the treatment of preferred shares that are issued by other financial institutions as a condition of participating in the recently enacted Troubled Asset Relief Program (“TARP”), preferred stock should be treated the same as common stock instead of debt for purposes of the asset coverage test, at least for a limited period of time.

Raising Capital at Less Than NAV

Currently, many BDCs are trading in the securities markets at prices below their NAV per share, which makes raising capital through equity offerings difficult under current regulations. The 1940 Act generally prohibits BDCs from selling their shares at a price below the current NAV per share, subject to limited exceptions for rights offerings or with the consent of shareholders. In addition, when their share prices are below NAV, the SEC Staff takes the position that BDCs are not permitted to utilize the shelf

© 2008 Sutherland. All Rights Reserved.

This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

1

registration process to flexibly access market windows like their commercial finance company competitors.

Because permissible rights offerings take substantial periods of time and are subject to market and pricing volatility and the adverse impact of short selling techniques, such rights offerings are often impracticable in a turbulent market environment. Consequently, the White Paper urges the SEC to clarify its rules to permit BDCs to sell their stock off of a shelf registration statement at a price that is below NAV. The SEC should also permit BDCs, with the consideration and approval of their boards, to issue shares below NAV without shareholder approval for some limited period of time necessary for them to bridge the current frozen capital markets, and subject to reasonable limits and conditions. The White Paper acknowledged that such temporary authority could be conditioned on: (1) requiring that shareholders be given advance notice of a BDC's intent to issue sales of shares below NAV, (2) restricting affiliates of the BDC from purchasing shares at a price that is below NAV other than on a basis that is *pari passu* with those of other shareholders, and (3) placing reasonable quantitative limitation on such issuances of shares.

Use of Amortized Cost for Valuation

The White Paper urges another simple change that would greatly assist BDCs in providing much-needed capital to small- and middle-market companies: the SEC should use its authority under § 2(a)(41) of the 1940 Act to permit BDCs to value at amortized cost fully performing loans and debt securities determined to be held to maturity ("covered assets"). The relief would apply only if the covered asset is fully performing and not viewed as being in danger of becoming nonperforming or requiring any material covenant modification or waiver. This change would parallel the accounting treatment available to commercial finance companies that are not regulated as BDCs.

BDC Participation in the TARP

In addition to the regulatory actions cited above, we believe that BDCs should be eligible to participate in the TARP—Capital Purchase Program (the "Program") under the Emergency Economic Stabilization Act of 2008 (the "EESA"). Pursuant to the terms of the Program, the U.S. Department of Treasury ("Treasury") will make available up to \$250 billion of capital to qualifying U.S.-controlled financial institutions. The capital will be injected in the form of non-voting preferred stock.

As provided in the EESA, Treasury determines which institutions are eligible to participate. Thus, although the Treasury has permitted only banking institutions to participate in the Program to date, it would appear appropriate, and within its power, to permit specialty finance companies, such as BDCs, to participate in the Program. As a result, we, along with other members in the BDC industry, are in the process of requesting that Treasury declare that BDCs are eligible to participate in the Program. We believe that by permitting BDCs to participate in the Program, Treasury will further its goal of restoring confidence and stability in the U.S. financial markets by providing capital to those companies, such as BDCs, that will, in turn, invest and reinvest such capital in U.S. small- and middle-market companies that have few, if any, alternative sources of capital in the current financial environment.

We will continue to keep you informed on the progress of this initiative.

The Non-Listed Structure: An Alternative for BDCs

In September 2008, the SEC cleared the initial public offering of FS Investment Corporation ("FSIC"), the first non-listed business development company. Sutherland served as issuer's counsel to FSIC. The

approval of this offering provides newly formed BDCs with an alternative mechanism to conduct an initial public offering and raise proceeds from retail investors, even in the current market environment.

FSIC's IPO was modeled after successful IPOs conducted by non-listed real estate investment trusts ("REITs"). According to the Investment Program Association, an advocacy group for non-listed vehicles, during the first half of 2008 investments in non-listed vehicles, including non-listed REITs, exceeded \$5.3 billion. During 2007, non-listed REITs raised approximately \$11.5 billion in proceeds from continuous public offerings.

While the shares sold in the continuous offering will not initially be listed on an exchange, FSIC intends to list its shares on an exchange or liquidate its assets by 5 to 7 years after the offering is completed. Prior to such time, FSIC intends to offer to repurchase a limited number of shares held by investors on a quarterly basis. The amount of shares that can be repurchased in a given year is capped at 10% of the weighted average number of shares during the prior year.

Why the Model Works for BDCs

Not subject to market volatility. Not listing a BDC's shares on an exchange has its advantages, especially in the current economic environment. The lack of a public trading market separates the net asset value of a BDC's common stock from the value assigned to it by the public markets. For a BDC, this is beneficial since it enables the BDC to continue to raise capital based on the value of its assets rather than on the market value of its common stock. The structure can also be attractive to income-oriented investors who seek stable distributions from an entity whose common stock is not subject to the fluctuations of the public markets.

Limited liquidity to stockholders at a fair price. The non-listed structure also provides limited liquidity to stockholders at a price per share at or about net asset value. This enables the BDC to employ substantially all of its cash to fund investment opportunities, while also providing liquidity to investors at a price near or equal to the net asset value of the common stock, rather than at a price dictated by the public markets, which may be significantly less than the net asset value per share.

Ability to conduct an offering in even the most challenging environments. Finally, absent shareholder approval, BDCs are generally unable to sell shares of their common stock at prices below net asset value. Even for BDCs who have received shareholder approval, the Board of Directors must approve each offering of shares. The Board may be reluctant to do so if the market value per share is significantly less than the net asset value per share because of the immediate dilution to existing shareholders. As a result, many BDCs have struggled accessing the capital markets in recent quarters. A non-listed vehicle does not face this obstacle since all sales of shares are made at a fixed price or at a price at or above net asset value per share. As a result, a non-listed entity has more flexibility to continue raising funds even when the capital markets are essentially closed for many listed issuers.

Regulatory Issues

A public offering of shares of common stock of a non-listed issuer faces certain regulatory issues not encountered by companies whose shares are listed on an exchange. These regulatory issues include, but are not limited to, the following:

Blue Sky Review. Since the common stock issued by a non-listed vehicle is not a "covered security" as defined by the National Securities Markets Improvement Act, the securities must be registered in each state in which the issuer offers and sells its securities. In addition, investors in the offering must meet certain suitability standards as required by the states.

Updating Requirements. A continuous public offering of common shares is subject to the updating requirements of the Securities Act, which requires that any prospectus used for more than nine months

include financial statements that are no more than 16 months old. In addition, a company conducting a continuous public offering must also supplement its prospectus to reflect material events or to post-effectively amend its prospectus to reflect “fundamental changes” or to reflect changes to the company’s plan of distribution. Post-effective amendments are subject to review by the SEC and may, in certain instances, require that a company suspend its offering until such review is complete.

SEC Announces Global Settlement With Eight Former BDCs

On September 29, 2008, the SEC announced that it had settled enforcement proceedings against eight companies¹ (the “Settlements”) for violations of the 1940 Act during the periods in which each of these companies had operated as a BDC. In addition, the SEC announced that an additional former BDC² was named in an administrative enforcement proceeding.

The common thread running through the Settlements was that most if not all of the respondents were operating companies that determined or were influenced to become BDCs in order to avail themselves of the opportunity to issue stock in an exempt offering under Regulation E. In so doing, the respondents committed violations of many of the fundamental provisions of the 1940 Act, including, for example, issuing shares for services, failing to maintain a fidelity bond, and failing to implement a compliance program. The Settlements each permanently suspend the respondent’s Regulation E exemption and provide that the respondent will cease and desist from committing or causing any violations and any future violations of the applicable provisions of the 1940 Act. Each of the respondents has withdrawn its election to be regulated as a BDC.

The Settlements underscore the SEC Staff’s ongoing, active focus on BDCs and suggests that the SEC Staff is developing an increasing sophistication with the BDC model, which, in turn, should make future compliance examinations more focused.

The text of the SEC’s press releases, as well as links to each settlement order, can be found at: <http://www.sec.gov/news/digest/2008/dig093008.htm>.

¹ The eight companies are (1) StarInvest Group, Inc.; (2) Green Globe International, Inc.; (3) CLX Medical, Inc.; (4) S3 Investment Company, Inc.; (5) Aero Performance Products, Inc.; (6) Atlantis Technology Group; (7) American Energy Production, Inc.; (8) Global Beverage Solutions, Inc.

² Rudy 45

If you have any questions or would like additional information, please contact the Sutherland attorney with whom you regularly work. The attorneys in Sutherland’s BDC Team are listed below.

Steven B. Boehm	202.383.0176	steven.boehm@sutherland.com
Cynthia M. Krus	202.383.0218	cynthia.krus@sutherland.com
Harry S. Pangas	202.383.0805	harry.pangas@sutherland.com
John J. Mahon	202.383.0515	john.mahon@sutherland.com
Lisa A. Morgan	202.383.0523	lisa.morgan@sutherland.com
Cynthia R. Beyea	202.383.0472	cynthia.beyea@sutherland.com
Vlad M. Bulkin	202.383.0815	vlad.bulkin@sutherland.com
Anne W. Gray	202.383.0966	anne.gray@sutherland.com
Carol W. Khalil	202.383.0596	carol.khalil@sutherland.com
Hannah L. Orowitz	212.389.5085	hannah.orowitz@sutherland.com
Owen J. Pinkerton	202.383.0254	owen.pinkerton@sutherland.com
Payam Siadatpour	202.383.0278	payam.siadatpour@sutherland.com

Maeve M. Ulrick

202.383.0915

maeve.ulrick@sutherland.com

For more information about the publicly traded private equity space, please visit Sutherland's Web site, www.publiclytradedprivateequity.com.

If this newsletter was forwarded to you and you would like to receive future issues, please e-mail Alexandria Palamountain at alexandria.palamountain@sutherland.com.