

Steven B. Boehm, Partner
Cynthia M. Krus, Partner

November 10, 2010

The ABCs of BDCs

SUTHERLAND

© 2010 Sutherland Asbill & Brennan LLP

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.

www.sutherland.com

Speakers

SUTHERLAND



Steven B. Boehm
Partner
202.383.0176
steven.boehm@sutherland.com



Cynthia M. Krus
Partner
202.383.0218
cynthia.krus@sutherland.com

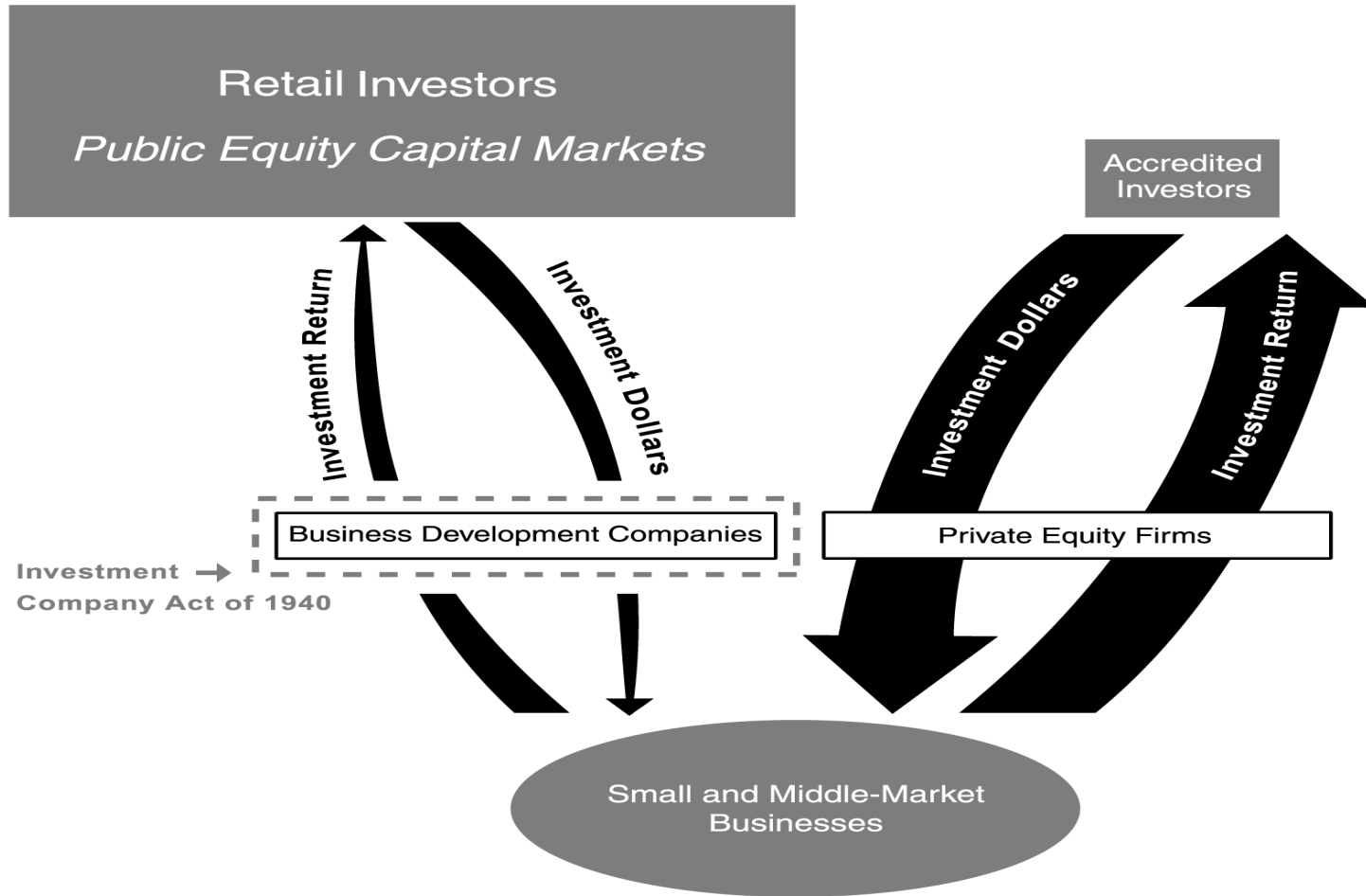
www.sutherland.com

©2010 Sutherland Asbill & Brennan LLP

What is a Business Development Company?

- Created by the Small Business Investment Incentive Act of 1980 (the “1980 Amendments”) as a result of a perceived crisis in the capital markets in the 1970s.
- Private equity and venture capital firms believed the “small private investment company” exemption (Section 3(c)(1) of 1940 Act) limited their capacity to provide financing to small, growing businesses.
- Regulated Investment Company (RIC) Status in 1990.
- Publicly traded closed-end funds that:
 - Provide small, growing companies access to capital.
 - Enable private equity funds to access the public capital markets.
 - Enable retail investors to participate in the upside of pre-IPO investing with complete liquidity.
- Hybrid between an operating company and an investment company.

What is a Business Development Company? (con't)



What are the Benefits of the BDC as an Investment Vehicle?

- Access to public capital markets
- Shares are traded on exchanges or Nasdaq
- Flow-through tax treatment
- Reduced burden under 1940 Act
- External model permits management fee and “carried interest” incentive fee structure
- Publicly available financial information through quarterly reporting
- Portfolio is typically diversified which reduces risk to investors associated with private equity investments
- Restrictions on leverage/affiliated transactions

How Did the BDC Industry Develop?

- Prior to 2003, the largest BDCs were primarily internally-managed. This choice was a reflection of the success of the internally managed, income producing BDC model.
- In 2004 Apollo Investment Corporation raised \$930 million in less than three months which ignited the BDC industry.
- There has been a steady stream of BDC IPOs since that period, raising approximately \$2.4 billion.
- IPO markets have opened up again for BDCs, comparable to 2004.
- The top 25 actively traded BDCs have approximately \$24.4 billion in assets under management.
- In the past five months of 2010, BDCs have raised over \$400 million in follow on transactions.

Recent Industry Trends

- The BDC model has proven to be resilient, as 2010 has been a year of recovery:
 - Resumption of dividend payments;
 - Increase in repurchase programs;
 - Lower asset coverage ratios.
- Of the top 25 actively traded BDCs, 13 are currently trading above NAV, seven are trading between 90% - 99% of NAV and five are trading a prices further below NAV.
- BDCs have shelf registration statements on file registering approximately \$7.5 billion of securities (including common stock, preferred stock, subscription rights, warrants and debt).

BDC IPO Activity 2010

- **The following BDCs completed their IPO*:**
 - Full Circle Capital Corp., \$18 million
 - Golub Capital BDC, Inc., \$102.95 million
 - Horizon Technology Finance Corporation, \$100 million
 - Solar Capital Ltd., \$92.5 million
 - THL Credit, Inc., \$199 million
 - Zea Capital Fund LLC, up to \$80 million
 - **The following BDCs have registration statements pending**:**
 - Age Reversal, Inc., \$20 million
 - Business Development Corporation of America, \$1.5 billion
 - Corporate Capital Trust, Inc., \$1.5 billion
 - FS Energy & Power Fund, \$1.5 billion
 - Gladstone Lending Corp., \$500 million
 - Medley Capital BDC LLC, \$200 million
 - New Mountain Guardian Corp., \$200 million
 - OFS Capital Corp., \$150 million
 - White Oak Capital Corp., \$200 million
- *Gross proceeds
** Target size

- Of the BDCs that have filed:
 - Four are blind pools.
 - The remainder have legacy portfolios or acquired portfolios investments from successor / affiliated funds.
- All are externally managed with:
 - Base management fees ranging from 1.375% to 2.0%,
 - Incentive fees consistent at 20% of net investment income and 20% of realized capital gains, with one exception which will employ a 15%/15% model.
 - Payment of incentive fees in stock
- Three of the IPOs are non-traded BDCs. Typical terms include:
 - Continuous offering
 - Suitability requirements
 - FINRA review
 - State blue sky review

Shelf Registration Statements

- In 2010 eight BDCs completed secondary offerings (in gross proceeds), for an aggregate of \$1.2 billion:
 - Apollo Investment Corporation - \$213.9 million
 - Ares Capital Corporation - \$292.7 million
 - BlackRock Kelso Capital Corporation - \$170.9 million*
 - Fifth Street Finance Corp. - \$187.6 million*
 - Main Street Capital Corporation - \$90.7 million*
 - PennantPark Investment Corporation - \$98.1 million* **
 - Solar Capital Ltd - \$157.8 million (selling stockholders)*
 - Triangle Capital Corporation - \$43.6 million
 - Two BDCs, Prospect Capital Corporation and Gladstone Capital Corporation, entered into equity distribution programs
 - Equity distribution agreement with investment bank acting as sales manager;
 - Commission of up to 2% of gross sales price of all shares sold
- * Includes 2 offerings
** Offering below NAV

- **Public debt offering**
 - Ares Capital Corporation – public issuance of \$200,000,000 in aggregate principal amount of 7.75% senior notes due 2040
- **Debt Restructuring**
 - American Capital, Ltd. – completed private exchange offers for its unsecured public and private notes for cash and new secured notes of various series
 - Among other restructuring, holders of American Capital’s unsecured public notes exchanged \$539 million of their notes for (i) an aggregate cash payment of \$11 million and (ii) \$4 million of new call-protected floating rate secured notes and \$524 million of new call-protected fixed rate secured notes
- **Exempt debt offering**
 - Apollo Investment Corporation - private placement issuance of \$225,000 in aggregate principal amount of five-year, senior secured notes with a fixed interest rate of 6.25% and a maturity date of October 4, 2015

- **Prospect Capital Corporation/ Patriot Capital Funding, Inc.**
 - Completed on December 2, 2009. The merger was effected pursuant to the Agreement and Plan of Merger dated August 3, 2009. Each outstanding share of common stock of Patriot was converted into the right to receive 0.363992367 shares of Prospect common stock.
- **Ares Capital Corporation/ Allied Capital Corporation**
 - Completed on April 1, 2010. The merger was effected pursuant to an Agreement and Plan of Merger, dated as of October 26, 2009. Each outstanding share of common stock of Allied Capital was converted into the right to receive 0.325 shares of Ares Capital common stock.
- **Saratoga Investment Corp./ GSC Investment Corp.**
 - Completed on July 30, 2010. Private sale of \$15 million in aggregate price of shares of common stock pursuant to a stock purchase agreement, dated April 14, 2010. In connection with the consummation of the transaction, the Company entered into a new \$40 million senior secured revolving credit facility, engaged Saratoga Investment Advisors as its investment adviser and changed its name to Saratoga Investment Corp.

How Does a Company Become a BDC?

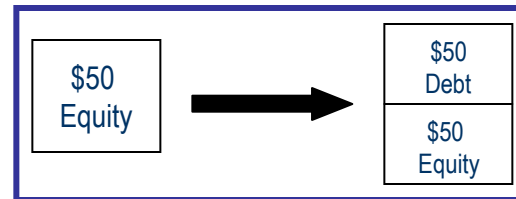
- Organize the BDC as a Delaware or a Maryland corporation
- Register a class of securities under the 1934 Act
- Make an election to be a BDC- file a Form N-54A (Notification of election to be subject to sections 55 through 65 of the 1940 Act)
- Register a class of securities on Form N-2 under the 1940 Act
- List securities on the New York Stock Exchange (NYSE), the Nasdaq Stock Market, Inc. (Nasdaq), or the NYSE AMEX, or the BDC can be a non-traded BDC
- Comply with the Sarbanes-Oxley Act of 2002 and Dodd-Frank Act
- Comply with regulatory requirements of the 1940 Act

What Must a BDC Invest In?

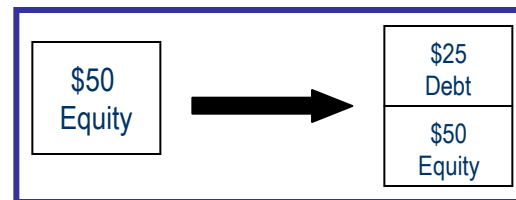
- A BDC can generally invest with flexibility in assets (“bad assets”) that do not fall within the “70% basket” if the investment:
- The SEC Staff has never been called upon to consider whether utilizing a specific strategy for the entire “30% basket,” e.g., investing solely in foreign companies, might run afoul of the intent of Section 55(a)
- The 70% basket includes securities issued by an eligible portfolio company, as defined in Section 2(a)(46)
 - Eligible portfolio companies include:
 - U.S. issuers that are neither an investment company as defined in section 3 (other than a wholly-owned SBIC) nor a company which would be an investment company except for the exclusion from the definition of investment company in section 3(c) and
 - (i) do not have any class of securities listed on a national securities exchange; or
 - (ii) have a class of securities listed on a national securities exchange, but have an aggregate market value of outstanding voting and non-voting common equity of less than \$ 250 million.
- SBIC investments generally meet the eligible portfolio company definition.

What are the Borrowing Limitations?

- BDCs Must have 200% asset coverage (Total Assets/Total Debt)
 - For example, a BDC with \$50 in equity can borrow up to \$50
 - A BDC would be able to invest \$100 in growing businesses



- Other investment companies are restricted to a 300% asset coverage requirement with respect to issuing debt



- BDCs may exclude leverage at the SBIC level if the Securities and Exchange Commission grants exemptive relief (for example, Hercules Technology Capital Growth, Inc. and MCG Capital Corporation)

Can a BDC Engage in Transactions with Affiliates?

- Section 57 addresses the ability of BDCs to engage in certain types of transactions with affiliates:
 - Section 57 is less onerous than its counterpart for registered investment companies, Section 17
- Depending on the nature of the affiliation with the BDC, transactions involving a BDC and one or more of its affiliates require either:
 - Authorization by the required majority of the board of directors, which consists of a majority of the board, including a majority of disinterested board members; or
 - An order of the Commission.

What are the 1940 Act Operational Requirements?

- BDC must have a majority of independent directors - persons who are not “interested persons” as defined in Section 2(a)(19) of the 1940 Act.
- BDCs must make available significant managerial assistance to these companies
 - SBICs generally already provide managerial assistance to the portfolio company
- **Custodian Agreement**
 - A BDC generally must place and maintain its securities and similar investments in the custody of a bank qualified under Section 26(a)(1) of the 1940 Act or a broker dealer.
- **Fidelity Bond**
 - A BDC must provide and maintain a bond issued by a reputable fidelity insurance company to protect the company against larceny and embezzlement. The bond must cover each officer and employee with access to securities and funds of the company.

What are the 1940 Act Operational Requirements? (con't)

- Restrictions on Investing in Other Investment Companies
 - A BDC may not invest:
 - in more than 3% of the outstanding voting stock of an investment company;
 - more than 5% of the value of its total assets in an investment company; or
 - more than an aggregate of 10% of its total assets in investment companies.
- Restrictions on investment funds investing in a BDC
 - Neither a public (i.e. registered) or private investment fund may own more than 3% of the outstanding voting stock of a BDC
- Code of Ethics
- Limitations on Indemnification
 - A BDC is prohibited from protecting any director or officer against any liability to the company, or its security holders, arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

What are the 1940 Act Operational Requirements? (con't)

- Compliance Policies and Procedures for the BDC – Rule 38a-1
 - Rule 38a-1 under the 1940 Act requires a BDC to:
 - adopt and implement policies and procedures designed to prevent violation of the federal securities laws;
 - review these policies and procedures annually for their adequacy and the effectiveness of their implementation; and
 - appoint a chief compliance officer to administer the compliance policies and procedures.
- Compliance Policies and Procedures for the investment adviser– Rule 206(4)-7 of the Investment Advisers Act of 1940
 - requires an investment adviser of a BDC to adopt and implement policies and procedures.
- Bookkeeping and Records Requirements - BDCs are required to maintain records
- Examinations by the SEC

What are the Reporting Requirements?

- Form 10-K (Annual Report)
- Form 10-Q (Quarterly Report)
- Form 8-K (Current Report)
- Proxy Statements
- Sections 13 and 16 Filings
 - Forms 3, 4 or 5 for reporting beneficial ownership by insiders
 - Schedules 13D and 13G for reporting beneficial ownership by others
- Regulation G and Regulation FD
- Comply with the Sarbanes-Oxley Act of 2002
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting/Attestation

What are the NYSE/Nasdaq/NYSE AMEX Reporting Requirements?

- BDCs that have their securities listed or traded on the NYSE, Nasdaq or NYSE AMEX must comply with the corporate governance listing standards of the relevant association or exchange. For example:
 - A listed BDC must have an audit committee composed solely of “independent directors” (as defined by the applicable exchange or association);
 - Director nominees of a listed BDC must be selected or recommended for the Board’s selection by a nominating committee or the vote of a majority of the BDC’s independent directors (depending on the exchange);
 - For internally managed funds, the compensation of a BDC’s executive officers must be subject to the oversight of the BDC’s “independent directors”;
 - The non-management, or “independent,” directors of the BDC must hold regularly scheduled executive sessions;
 - The BDC must adopt a code of business conduct and ethics, various committee charters and, in the case of NYSE listed BDCs, corporate governance guidelines.
 - All such documents must be posted on the company’s website; and
 - BDC must comply with the corporate governance provisions of Dodd-Frank Act applicable to BDCs generally.

How Are a BDC's Assets Valued?

- Assets must be valued on a quarterly basis
 - Market value is used for those assets for which market quotations are readily available
 - “Fair value,” as determined by the board of directors, is used for other securities and assets
 - Each debt and equity security is separately valued
- There is no single standard for determining fair value in good faith
- Determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process
- ASC 820 requires that public companies' financial instruments generally be valued at their current market price (i.e., “mark to market”)
- SBIC valuation policy may be different from the SEC regulations

How Can an Internally Managed BDC Compensate Management?

SUTHERLAND

- Certain performance-based compensation permitted, including:
 - Issuance of at-the-market options, warrants, or rights pursuant to an executive compensation plan;
OR
 - Maintenance of a profit sharing plan.
- Otherwise, BDC must use cash assets as compensation
- Restricted stock – exemptive orders have been issued to BDCs, including Hercules Growth Technology, Inc., MCG Capital Corporation and Main Street Capital Corporation

How Can an Externally Managed BDC Compensate the Adviser?

- The investment adviser must be registered under the Investment Advisers Act of 1940
- The Advisers Act contains no prohibition against an adviser taking an incentive fee against income, although the market has effectively capped these fees at 20%, usually subject to a hurdle.
- This contrasts with incentive fees from capital gains, which are expressly prohibited unless assessed pursuant to an exception like that provided in Section 205(b)(3) of the Advisers Act.

How is the Adviser's Incentive Fee Calculated?

- SEC Staff has taken no formal position on the calculation of the fee but requires BDCs to contain extensive disclosure in registration statements regarding the manner in which the fee will be calculated in varying scenarios.
- Section 205(b)(3) of the Advisers Act permits external investment advisers to BDCs to receive incentive fees, provided that the BDCs do not have outstanding any equity-based compensation arrangement or profit-sharing plan.
 - Section 205(b)(3) provides an exception from the general prohibition on an investment adviser charging an incentive fee based on a share of capital gains.
 - May assess an incentive performance fee of up to 20% on a BDC's realized capital gains net of all realized capital losses and unrealized capital depreciation over a specified period.
- Section 205(b)(3) of the Advisers Act makes no reference to whether the unrealized capital depreciation by which the fee must be reduced includes:
 - only depreciation below the original cost of the security in question, or
 - whether it includes a decrease in value in a security above the original cost but below the point of a previous unrealized capital appreciation.

How are BDCs Taxed?

- A BDC may elect to be taxed as a regulated investment company (“RIC”) under the Internal Revenue Code
 - Taxation as a RIC
 - Allows “pass through” tax treatment for income and capital gains that are distributed to shareholders
 - A BDC must distribute at least 90% of its investment income to shareholders annually
 - The BDC may retain, distribute or “deem distribute” capital gains
 - BDC must meet minimum source of income requirements annually and meet requirements on a quarterly basis with respect to the portfolio diversification
 - Conversion to RIC status

- **SBIC Subsidiaries**
 - Eight BDCs have SBIC subsidiaries, two licensed for externally managed BDCs within the last year.
 - Provides access to low-cost debt (a fully funded SBIC with \$75 million in regulatory capital can access up to \$150 million in leverage from the SBA with an option for a second license for an additional \$75 million).
- **Fund Formation**
 - Some BDCs are using BDCs as asset managers. The benefit of this structure is the fee income received.
- **Fund Platforms**
 - Some BDCs are building a platform of funds that complement the BDC's business.

Are There BDCs That Have SBIC Subsidiaries?

SUTHERLAND

- Two (2) SBICs elected to become BDCs and conducted successful IPOs
 - Main Street Capital Corporation/\$64,500,000
 - Triangle Capital Corporation/\$71,550,000
- BDCs that have received an SBIC license for a wholly-owned subsidiary
 - Fifth Street Finance Corp.
 - Hercules Technology Growth Capital, Inc.
 - Medallion Financial Corp.
 - MCG Capital Corporation
 - PennantPark Investment Corporation
 - Rand Capital Corporation

How Does an SBIC Convert to a BDC?

SUTHERLAND

- Conversion Transaction
 - Approval of LPs in advance of valuation and merger
 - Merger of SBIC into subsidiary of BDC
 - Amend Limited Partnership Agreement
 - SBA Approval
- SEC Review
 - Affiliate Transaction Issues
 - Compensation Issues
 - Disclosure Issues

- Exemptive Relief
- Relief to get SBIC leverage treatment at BDC level
- Section 18(a):
 - Question of whether BDC with an SBIC subsidiary must comply with the asset coverage requirements of Section 18(a) (as modified by Section 61(a) for BDCs) on a consolidated basis.
 - The senior securities issued by the SBIC Subsidiary would be excluded from the SBIC Subsidiary's individual asset coverage ratio by Section 18(k) if the SBIC Subsidiary were a BDC.
 - Exemption requested- senior securities representing indebtedness issued by the SBIC Subsidiary may be excluded from the BDC's consolidated asset coverage ratio.

What are the Incentives for an SBIC to Convert to a BDC?

- Why Are BDCs Attractive to SBICs?
 - Ability to Access Public Market
 - Flexibility in Funding Portfolio Investments
 - Permanent Capital Base
 - Additional Compensation Incentives
- Why Are SBICs Attractive to the BDC Market?
 - Existing Portfolio – not blind pool
 - Existing management team with track record
 - Market niche – lower middle market
 - Additional leverage capacity

Questions?

SUTHERLAND



Steven B. Boehm
Partner
202.383.0176
steven.boehm@sutherland.com



Cynthia M. Krus
Partner
202.383.0218
cynthia.krus@sutherland.com