THE BUSINESS DEVELOPMENT COMPANY SOLUTION

A Special Category of Closed-end Investment Company, BDCs Can Provide a Workable Alternative for Public Participation in Traditionally Private Venture Capital Funds. Under the 1940 Act, BDCs Must Invest in Developing Businesses, But Have More Flexibility to Borrow, and May Compensate Employees with Equity-based Products.

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"The Review of Securities & Commodities Regulation, An Analysis of Current Laws and Regulations Affecting the Securities and Futures Industries,"
Vol. 34, No. 4, February 28, 2001

Venture capital funds have traditionally been available only to institutions and wealthy individuals through private placements. To the extent these sources of private capital prove sufficient, reliance on public investors is not necessary, and concerns about the possible applicability of the Investment Company Act of 1940 (the "1940 Act") can be avoided by limiting participation to 100 or fewer investors or to extremely wealthy "qualified purchasers."[1]

Increasingly, however, venture capitalists have displayed an interest in attracting public investors to their historically private realm. And the public has been receptive. More average investors are being lured by the siren song of investments in start—up and pre—IPO companies, and have come to view such investments as important, and perhaps even necessary, components of a properly diversified portfolio.

The confluence of the increasing demand for venture capital and the appetite of the public to provide it has resulted in a proliferation of public venture capital companies. While not threatening to equal, or even approach, their mutual fund counterparts, public venture capital funds are slowly emerging as realistic alternatives for mainstream investors who historically had never before thought of, or thought of themselves, as venture capitalists.

Companies seeking to attract venture capital dollars from the public fall into two distinct categories. First, there are the entities like CMGI, Internet Capital Group, Bill Gross's Idealab!, and Safeguard Scientifics, which operate so as to avoid the regulatory protocols of the 1940 Act. Those companies generally rely on either: (1) the exclusion from investment company status under Rule 3a-1 of the Act, which generally provides that a company will not be considered an

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[1] Section 3(c)(1) of the 1940 Act excludes from the definition of "investment company" any entity that is not making and does not intend to make a public offering and whose outstanding securities are held by no more than 100 persons. Section 3(c)(7) excludes an entity not making or intending to make a public offering the outstanding securities of which are owned exclusively by "qualified purchasers." Pursuant to Section 2(a)(51) of the 1940 Act, the term includes, among others, individuals with not less than $5 million, and entities with not less than $25 million, in investments.

investment company if no more than 45 percent of the value of its assets consists of "investment securities,"[2] and no more than 45 percent of its after-tax net income is derived from such securities, or (2) an exemptive order from the Securities and Exchange Commission pursuant to Section 3(b)(2) of the 1940 Act declaring the applicant to be primarily engaged in a non-investment company business and therefore not subject to the Act.

Companies relying on either Rule 3a-1 or an SEC exemptive order are not subject to the provisions of the 1940 Act. However, depending on the exemption on which they rely, such companies remain subject to either the strict numerical limitations of Rule 3a-1 or the conditions upon which their exemptive orders were granted.

An alternative to relying on either Rule 3a-1 or an exemptive order is for a venture capital company that is seeking to access the public market to elect to be regulated under the 1940 Act as a business development company (a "BDC"). Although BDCs have been part of the 1940 Act landscape since 1980, recently their visibility has been increasing. In March of 2000, meVC Draper Fisher Jurvetson completed a $350 million offering, at the time the largest IPO for a BDC, and other new entrants in the BDC field have also appeared.[3] In addition, Excelsior Venture Partners Investors, III, LLC recently amended its registration statement to increase its proposed public offering to $800 million. Existing BDCs have also continued to funnel public dollars into small businesses, either as the public equivalent of traditional private equity funds *(e.g.,* Harris & Harris Group, Brantley Capital Corporation, Renaissance Capital) or as mezzanine lenders *(e.g.,* Allied Capital Corporation, PMC Capital, Inc. and American Capital Strategies, Ltd.).

ORIGINS

In the 1970s, a perceived crisis in the capital markets led Congress to enact the Small Business Investment Incentive Act of 1980 (the "1980 Amendments ").[4] As a statutory framework, the 1980 Amendments were designed to put in place a workable approach to the regulation of a public vehicle investing in private equity. By focusing on those provisions of the 1940 Act that created unnecessary obstacles to the formation of a publicly-held, private-equity fund, Congress believed that small businesses would benefit from capital sources previously unavailable. Thus, the 1980 Amendments forged a regulatory framework for BDCs from the core provisions of the 1940 Act.

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[2] "Investment Securities" is defined in Section 3(a)(2) of the 1940 Act to include all securities except:

> (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in [Section 3(c)(1) or 3(c)(7)].

[3] Recent entrants include such companies as UTEK Corporation, Orbital Life Sciences , Biotechnology Fund, Inc., and Peacock Financial.

[4] Pub. L. No 96-477, 94 stat. 2275.

This legislation attempted to eliminate provisions of the 1940 Act that created unnecessary disincentives to private equity investment extant in the regulatory framework of the time. Open—end investment companies mutual funds—could not by definition invest to a meaningful extent in small businesses in light of their fundamental need for liquidity; registered closed—end investment companies, for their part, were considered unappealing as venture capital funds in light of their limitations on borrowing and inability to compensate management with equity, a venture capital *sine qua non.* The centerpiece of the 1980 Amendments was the advent of a new category of closed—end investment company subject to the 1940 Act, but operated as a venture capital enterprise—the business development company, or BDC.

The specific provisions of the 1940 Act regulating BDCs fall into two distinct categories. The first category includes those provisions that directly or indirectly promote investment in developing businesses. Examples of these provisions include lower asset coverage requirements for borrowing, mandatory investment in small businesses (as a percentage of the company's total assets), and relaxed restrictions on affiliated transactions. The second category includes those provisions designed to compensate employees of BDCs in a manner consistent with compensation practices in the venture capital industry. Examples of such provisions include permitting the company to issue certain types of equity—based compensation to employees and permitting the company to make loans to employees of the company to enable them to purchase the company's securities. Collectively, these provisions were designed to achieve Congress's goal of promoting capital investment in small businesses by encouraging venture capitalists previously unwilling to submit to 1940 Act regulation to establish public funds for private investment.

REGULATORY STRUCTURE

Electing to be a BDC and 1934 Act Registration

The 1980 Amendments provide a general exemption for BDCs from the provisions of the 1940 Act and make them subject to Sections 54 through 65 of the 1940 Act, which relate specifically to BDCs (the "BDC provisions"). To qualify for the exemption, a closed-end investment company must elect to be treated as a BDC and file a notice to that effect with the SEC.

Significantly, to make the BDC election, a company must also have a class of its equity securities registered under the Securities Exchange Act of 1934 (the "1934 Act"). As a result, shares of BDCs, like those of closed-end funds, typically are listed for trading on public exchanges or on a Nasdaq market. However, unlike closed-end funds, which are not required to register under the 1934 Act, BDCs must file with the SEC periodic reports *(i.e.,* Forms 10-Q and 10-K) and other reports *(e.g.,* Form 8-K) like those filed by publicly traded operating companies. Management personnel also must report their trading in the company's stock and are restricted from obtaining short swing profits from trading in such securities within a six-month period. Like other 1934 Act registrants, BDCs are also subject to the proxy solicitation requirements of Section 14 of that Act.

Required Investments

Consistent with the Congressional purpose behind the 1980 Amendments, a BDC is, in effect, required by Section 55(a), to have at least 70% of its investments in eligible assets. Eligible assets, for purposes of Section 55(a), include, among other things, (i) securities of an "eligible portfolio company" that are purchased from that company in a private transaction, (ii) securities received by the BDC in connection with its ownership of securities of an "eligible portfolio company," or (iii) cash, cash items, government securities, or high quality debt securities maturing one year or less from the time of investment. As a practical matter, "eligible portfolio companies" are limited for the most part to domestic companies that are not investment companies and that cannot have a class of securities listed on a national securities exchange or have securities that are marginable.

Managerial Assistance

BDCs are required to make available significant managerial assistance to their portfolio companies. Significant managerial assistance refers to any arrangement whereby a BDC provides significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company. Examples of such activities include arranging financing, managing relationships with financing sources, recruiting management personnel, and evaluating acquisition and divestiture opportunities.

Capital Structure

The 1980 Amendments reflect Congress's recognition of the common practice of venture capital enterprises to issue derivative securities to management and others. Consequently, unlike other investment companies, BDCs are able to issue options, warrants, and rights to convert to voting securities to its officers, employees and board members.

Any issuance of derivative securities requires the approval of the company's board of directors and authorization by the company's shareholders. The company also may not issue derivative securities to its non-employee directors unless it first obtains an exemptive order from the SEC.

In general, the amount of voting securities that would result from the exercise of all derivative securities of a BDC at the time of issuance is not permitted to exceed 25% of the outstanding voting securities of the BDC. However, if the outstanding derivative securities issued to management personnel as a component of their compensation represents 15% of the BDC's outstanding shares, then the total amount of derivative securities that the BDC may issue, as a percentage of its total outstanding shares, is 20%.

A BDC may operate a profit-sharing plan for its employees, subject to certain restrictions. A BDC cannot, however, maintain such a plan if it maintains a stock option plan for management, or is externally managed by a registered investment adviser.

Leverage

BDCs are less restricted than closed-end funds as to the amount of debt they can have outstanding. Generally, a BDC may not issue any class of senior security representing an indebtedness unless, immediately after such issuance or sale, it will have asset coverage of at least 200%. (Thus, for example, if a BDC has $1 million in assets, it can borrow up to $1 million, which would result in assets of $2 million and debt of $1 million.) Other investment companies must have 300% asset coverage.

Operational Considerations

As with any other company subject to the 1940 Act, a BDC must adhere to certain substantive regulatory requirements with respect to its operations.

Composition of Board of Directors. A majority of the directors of a BDC must be persons who are not "interested persons" of the BDC. The 1940 Act defines interested persons to include, among others: (i) officers, directors, and employees (however, no person is deemed to be interested solely by reason of being a member of the board of directors); (ii) a five percent or more voting shareholder of the company; (iii) a person who is a member of the immediate family of an affiliate of the company; (iv) legal counsel for the company; and (v) any natural person whom the SEC determines to have had a material business relationship in the past two completed fiscal years with the company or its chief executive officer.

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. This prohibition also applies to the company's investment adviser, if it is externally managed.

Valuation. The board of directors of a BDC is required to value portfolio assets on a quarterly basis in connection with filing certain required periodic reports. Assets must be valued on the basis of market value, if available; in the absence of a readily ascertainable market value for an asset, the board must in good faith determine the "fair value."

Transactions with Related Persons. Transactions involving a BDC and certain persons related to it including, among others, officers, directors, employees, members of an advisory board, the investment adviser, the principal underwriter, and persons controlling or under common control with the BDC, are generally prohibited, absent an SEC exemptive order. Transactions involving a BDC and companies that it controls *(i.e.,* those in which it owns more than 25% of the voting securities) generally are not subject to this limitation.

Code of Ethics. Officers and directors of a BDC, and its external investment adviser (if any) are subject to general fiduciary duties with respect to the conduct of their duties as they impact the BDC. A BDC (and its investment adviser) must adopt a code of ethics and institute procedures reasonably necessary to ensure that its employees and certain affiliates adhere to the code.

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, with the required coverage tied to the amount of the company's assets.

TAXATION

A BDC may elect to be taxed either as a "C corporation" (like typical operating companies) or as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986. As a regulated investment company (a "RIC"), a BDC can avoid taxation at the company level on that portion of income and capital gains distributed to shareholders. To qualify for RIC treatment, in general at least 90% of the BDC's income must consist of interest, dividends, gains from sales of securities and similar types of income and gains and the BDC must distribute to its stockholders for each taxable year at least 90% of its investment company taxable income (consisting generally of net investment income from interest and dividends and net short-term capital gains). The RIC provisions also require a BDC to comply with certain requirements with respect to its portfolio diversification.

CHOOSING THE RIGHT COURSE

Whether an entity in the business of investing in the securities of other companies should elect the BDC structure or rely on the exemptions available under the 1940 Act or an SEC exemptive order depends on the business model chosen. Ideally, if a substantive regulatory regime like the 1940 Act can be avoided consistent with a public venture fund's strategic objective and tactical intentions, that result should be pursued. Thus, promoters of public venture funds should first consider whether reliance on a regulatory exemption or SEC exemptive order is feasible.

If the company's business model permits it to fall within the assets and income tests of Rule 3a-1, that approach would likely be the simplest. Before taking this route, however, company promoters should carefully consider whether they anticipate that the company will be able to remain within the Rule's parameters under all foreseeable business conditions.

If Rule 3a-1 is determined not to be a viable option because greater operational flexibility is needed or for some other reason, then the company should consider whether an SEC exemptive order along the lines of those received by ICG and Idealab! under Section 3(b)(2) of the 1940 Act would work. The SEC has displayed a willingness in those cases to apply the basic principles it has for years applied in granting exemptive orders to public venture funds operating as business incubators. In these cases, as in Rule 3a-1, the key is that the fund is designed to invest in portfolio companies for control. To the extent, then, that a fund seeks the flexibility to invest a substantial portion of its assets in portfolio companies in which it will own 25% or less of the outstanding securities, the ICG/Idealab! approach may not be suitable.

The BDC solution makes sense where the desire for greater flexibility with respect to the percentage of each portfolio's voting securities to be owned is critical. In those cases, compliance with the BDC provisions of the 1940 Act permits the entity to avoid the fetters of the Rule 3a-1 assets and income tests and the conditions that are routinely imposed in connection with an exemptive order issued under Section 3(b)(2). Consequently, the BDC solution removes the uncertainty of the company's ability to continue to meet percentage requirements and other limitations on operations inherent in the exemptive approaches outlined above.

MAKING THE BDC REGIME MORE WORKABLE

Recently, a number of BDCs, as well as companies considering adopting that structure and others with an interest in BDC issues, joined together to establish the Committee for the Modernization of BDC Regulation (the “Committee”).[5] The purpose of the Committee is to promote the common interests of BDCs and to make the structure more viable in the current economic environment.

In furtherance of its goal, the Committee has established a dialogue with the staff of the SEC’s Division of Investment Management in an effort to determine whether, consistent with the small-

[5] The authors of this article serve as counsel to the Committee.

business enhancing purposes of the 1980 Amendments, regulatory or interpretive changes can be made that would make the BDC structure more viable. Among the matters on which the Committee is focused are capital raising, compensation, and operations (including transactions with affiliates).

CONCLUSION

The BDC structure must be considered as part of a thorough analysis of the appropriate structure for a public venture capital fund. To the extent that the fund's investment strategy or anticipated capital resources would make investing for control of portfolio companies unlikely, the BDC solution may be the most workable.