

BDC ROUNDTABLE

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Disclosure Reform

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Overview

- Regulatory Reform
- Impact of Amended NYSE Rule 452 on the Election of Directors
- Sales of Shares Below NAV
 - Shareholder Approval
 - Shelf Registration Statement Procedure
- BDC Securities Offering Reform
 - Shelf Registration Statements
 - Free Writing Prospectuses
 - Prospectus Delivery
- Disclosure Considerations in a Turbulent Financial Market
- Consolidation within the BDC Industry
 - Proxy Statement/ Prospectus
 - Post-Effective Amendment to Shelf Registration Statement

Shareholder Access to the Company Proxy Statement

- The Proxy Access Proposal provides that shareholders not seeking to change control of an issuer and owning a specified percentage of a company's stock for at least one year may nominate directors for inclusion in the company's proxy statement.
- Two components of the Proxy Access Proposal:
 - New Rule 14a-11
 - Amendment to Rule 14a-8(i)(8)
- New Schedule 14N
 - Certification that the shareholder is not seeking to change control of the company or gain more than minority representation on the board of directors.
 - Disclosure regarding shareholder's securities owned, length of ownership, and intent to continue to hold the securities through the date of the annual meeting.

Advisory Votes on Executive Compensation

- An advisory vote on executive compensation, or “Say on Pay Proposal,” is a non-binding proposal included in a company’s proxy statement that calls for an annual shareholder advisory vote on a company’s executive compensation program.
- Say on Pay Proposals originated in U.K. with similar movements in Australia, the Netherlands, Norway and Sweden.
- Tool used by activist shareholders and institutional investors in the U.S. beginning in 2006.
- Recipients of TARP funds must put their executive compensation to a non-binding shareholder advisory vote.
- The *Investor Protection Act of 2009* would require all public companies to put their executive compensation to a non-binding shareholder advisory vote at any annual meeting held after December 15, 2009.
- Some companies, including BDCs, have voluntarily included Say on Pay Proposals in their proxy statements.

Executive Compensation

- The Obama Administration, Congress and the SEC have each taken action in an effort to address public outcry over executive compensation in the wake of the collapse of several large financial institutions and the economic recession.
 - Executive compensation and corporate governance standards under the American Recovery and Reinvestment Act of 2009 (for TARP recipients)
 - SEC amendments to disclosure requirements under the proxy rules
 - A variety of legislation introduced in both the House and the Senate.
- Treasury outlined the following best practices for a compensation program:
 - Properly measure and reward performance;
 - Structured to account for the time horizon of risk;
 - Aligned with sound risk management; and
 - Promote transparency and accountability in the compensation-setting process.

Independence of Compensation Committee Members and Compensation Consultants

- Draft legislation and SEC amendments would revise the definition of independence for directors serving on the compensation committee so that members may not receive any consulting, advisory or other compensatory fees and may not be an affiliated person of the issuer.
- If a compensation consultant works for both company management and the compensation committee, the company would need to include the following disclosure in its proxy statement:
 - Description of nature and scope of additional services;
 - Aggregate fees paid for executive and director compensation consulting and the aggregate fees paid for all other services;
 - Whether the decision to engage the compensation consultant for these other services was made, recommended or reviewed by management; and
 - Whether the board or the compensation committee approved the additional engagements.

Risk Management, Risk Assessments

- Many believe the effects of undue risk-taking are the central catalyst behind the collapse of the economy.
- Risk management and risk assessments have become common themes of recent regulatory and legislative action.
 - For example, the compensation committees of the boards of directors of recipients of TARP funds must evaluate the company's incentive compensation plans and arrangements to ensure that they do not encourage executive officers to take unnecessary or excessive risk that threatens the value of the company.
- Conducting risk assessments is an emerging best practice.

Amended NYSE Rule 452

- Amended Rule 452 eliminates discretionary broker voting for the election of directors.
 - The election of directors is deemed a “non-routine” matter and brokers may not vote the shares of the beneficial owners unless instructed to vote by the beneficial owners.
- Effective for shareholder meetings held on or after January 1, 2010.
- Amended Rule 452 does not apply to registered investment companies but does apply to BDCs.

Amended NYSE Rule 452

- Sutherland submitted a comment letter to the SEC regarding proposed changes to NYSE Rule 452 in March 2009. The ICI submitted a similar letter.
- Sutherland requested that the SEC extend the exception to the application of Amended Rule 452 granted to registered investment companies to BDCs.
 - Amended Rule 452 would impose significant hardships on the BDC industry by creating difficulties in achieving a quorum and thereby increasing costs to BDCs as a result of adjournments and additional solicitations.
 - Like registered investment companies, BDCs have a higher proportion of retail shareholders than most operating companies. In fact, approximately 63% of BDC shares are held by retail investors, a percentage far greater than traditional operating companies.

Amended NYSE Rule 452

- The SEC’s Adopting Release included the following explanation for requiring BDCs to comply with Amended Rule 452:
 - “For example, the regulation of BDCs and registered investment companies under the 1940 Act differs significantly. Particularly relevant here, the 1940 Act requires a BDC to seek ratification of the independent auditor, which is a routine item under NYSE Rule 452, at each annual meeting. Adoption of the amendment will therefore have no effect on a BDC’s ability to obtain a quorum, and expansion of the exemption for registered investment companies to include BDCs is unnecessary. A registered investment company, however, is exempt from the 1940 Act’s auditor ratification requirement if it relies on a conditional exemptive rule under the 1940 Act. That exemptive rule is not available to BDCs.”

Amended NYSE Rule 452

- Arguments in Support of Amended Rule 452:
 - Improves Transparency
 - Increases Shareholder Activism
 - Reinstates the “One Share, One Vote” Principle
- Arguments in Opposition of Amended Rule 452:
 - Extensive Solicitation and Education Costs
 - Makes Obtaining a Quorum More Difficult
 - Directors’ Focus Shifts From Long-Term to Short-Term Goals
- In general, Amended Rule 452 is likely to provide institutional investors, proxy advisory firms and activist shareholders disproportionately greater influence over the election of directors because retail shareholders do not always vote.

Sales Below NAV – Shareholder Approval

- The 1940 Act requires the affirmative vote of:
 - a majority of the outstanding shares of common stock entitled to vote at the meeting; and
 - a majority of the outstanding shares of common stock entitled to vote at the meeting that are not held by affiliated persons of the Company is required to approve this proposal.
- The 1940 Act defines “a majority of the outstanding shares” as:
 - 67% or more of the voting securities present at the Meeting if the holders of more than 50% of the outstanding voting securities of such company are present or represented by proxy; or
 - more than 50% of the outstanding voting securities of the Company, whichever is the less.

Sales Below NAV – Shareholder Approval

- Difficulties with obtaining the required vote:
 - Effect of broker non-votes
 - Tracking shares held by affiliated persons
- Shareholder approval at a special meeting
 - Permitted despite the reference in Section 63(2) of the 1940 Act to shareholder approval at an annual meeting
 - Kohlberg Capital Corporation (pub. avail. Mar. 12. 2009)
 - Greater Washington Investors, Inc. (pub. avail. Oct. 21, 1983)

Sales Below NAV – Registration Statements

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- BDCs can conduct offerings of common stock at prices below NAV off of a new or existing shelf registration statement.
 - File a post-effective amendment
 - Limit cumulative dilution to 15%
- Additional disclosure is required in the base prospectus and the prospectus supplement, including:
 - Disclosure regarding effects on stockholders on front cover of prospectus and in risk factors
 - Dilution tables demonstrating dilutive and accretive effects on existing stockholders who participate, existing stockholders who do not participate and new investors
 - Chart reflecting the number of shares offered and the discount to NAV
 - Additional undertaking

Sales Below NAV – Registration Statements

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Sample dilution table:

	Prior to Sale Below NAV	Example 1 5% Offering at 5% Discount		Example 2 10% Offering at 10% Discount		Example 3 20% Offering at 20% Discount	
		Following Sale	% Change	Following Sale	% Change	Following Sale	% Change
Offering Price							
Price per Share to Public		\$ 12.42	—	\$ 11.77	—	\$ 10.46	—
Net Proceeds per Share to Issuer		\$ 11.80	—	\$ 11.18	—	\$ 9.94	—
Decrease to NAV							
Total Shares Outstanding	43,000,000	45,150,000	5.00%	47,300,000	10.00%	51,600,000	20.00%
NAV per Share	\$ 12.42	\$ 12.39	(0.24)%	\$ 12.31	(0.91)%	\$ 12.01	(3.33)%
Dilution to Nonparticipating Stockholder							
Shares Held by Stockholder A	43,000	43,000	0.00%	43,000	0.00%	43,000	0.00%
Percentage Held by Stockholder A	0.10%	0.10%	(4.76)%	0.09%	(9.09)%	0.08%	(16.67)%
Total NAV Held by Stockholder A	\$ 534,060	\$ 532,788	(0.24)%	\$ 529,205	(0.91)%	\$ 516,258	(3.33)%
Total Investment by Stockholder A (Assumed to be \$12.42 per Share)	\$ 534,060	\$ 534,060		\$ 534,060		\$ 534,060	
Total Dilution to Stockholder A (Total NAV Less Total Investment)		\$ (1,272)		\$ (4,855)		\$ (17,802)	
NAV per Share Held by Stockholder A		\$ 12.39		\$ 12.31		\$ 12.01	
Investment per Share Held by Stockholder A (Assumed to be \$12.42 per Share on Shares Held Prior to Sale)	\$ 12.42	\$ 12.42		\$ 12.42		\$ 12.42	
Dilution per Share Held by Stockholder A (NAV per Share Less Investment per Share)		\$ (0.03)		\$ (0.11)		\$ (0.41)	
Percentage Dilution to Stockholder A (Dilution per Share Divided by Investment per Share)			(0.24)%		(0.92)%		(3.45)%

Additional undertaking:

- “To file a post-effective amendment to the registration statement, and to suspend any offers or sales pursuant the registration statement until such post-effective amendment has been declared effective under the 1933 Act, in the event the shares of Registrant are trading below its net asset value and either (i) Registrant receives, or has been advised by its independent registered accounting firm that it will receive, an audit report reflecting substantial doubt regarding the Registrant’s ability to continue as a going concern or (ii) Registrant has concluded that a material adverse change has occurred in its financial position or results of operations that has caused the financial statements and other disclosures on the basis of which the offering would be made to be materially misleading.”

Sales Below NAV – Registration Statements

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- A BDC can complete multiple offerings off of an effective shelf registration statement only to the extent that the cumulative dilution to the BDC's NAV per share does not exceed 15%.
- Once the cumulative dilution to the BDC's NAV per share from multiple offerings off of a particular registration statement exceeds 15%, the BDC must file a new post-effective amendment or registration statement, which must be declared effective by the Staff.
- The amount of dilution incurred will be measured separately for each offering pursuant to a post-effective amendment by calculating the percentage dilution or accretion to aggregate NAV from that offering and then summing the percentage from each offering. A BDC must include these limitations in its post-effective amendment or registration statement and in each prospectus supplement.
- SEC Staff is considering revisiting their 15% cap requirement.

Example of Calculation of 15% cumulative dilution:

- If a BDC's most recently determined NAV at the time of its first offering off of its shelf registration statement is \$15.00 and it has 30 million shares outstanding, the sale of 6 million shares at net proceeds to the BDC of \$7.50 per share (a 50% discount) would produce dilution of 8.33%.
- If the BDC subsequently determined that its NAV per share increased to \$15.75 of the then 36 million shares outstanding and the BDC then made an additional offering, it could, for example, sell approximately 7.2 million additional shares at net proceeds to the BDC of \$9.45 per share, which would produce dilution of 6.66%, before the BDC would reach the aggregate 15% limit.

Sales Below NAV – Registration Statements

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- BDCs that have completed offerings of common stock below NAV:
 - Apollo Investment Corporation
 - Ares Capital Corporation
 - Fifth Street Finance Corp.
 - Main Street Capital Corporation
 - Prospect Capital Corporation
 - Triangle Capital Corporation

- In response to a request from the SEC staff and the ICI, Sutherland submitted a draft of a proposed rulemaking to the SEC for consideration regarding certain amendments to a number of rules (the “Amendments”) to permit BDCs to avail themselves of the rule changes adopted in connection with the SEC’s Securities Offering Reform in 2005 (the “Final Rules”).
- The Amendments address certain limitations placed on BDCs trying to access the public capital markets, including, among others:
 - Shelf Registration Statements
 - Free Writing Prospectuses
 - Prospectus Delivery
- A draft was submitted during Summer 2008. Sutherland has met with the Staff to discuss the Amendments.

BDC Securities Offering Reform

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- The Amendments are intended to recognize that:
 - BDCs are subject to all of the same disclosure and filing requirements under the Securities Exchange Act of 1934 (the “1934 Act”) as other issuers that have a class of securities registered under the 1934 Act (“1934 Act Registrants”), and
 - BDCs conduct registered offerings under the Securities Act of 1933 (the “1933 Act”) in the same manner as 1934 Act Registrants that file registration statements on Forms S-1 or S-3.

Shelf Registration Statements – Incorporation by Reference

- BDCs cannot use the integrated disclosure concept available to other 1934 Act Registrants using Form S-3 – that is, BDCs cannot incorporate information into their registration statements by reference to their periodic reports filed under the 1934 Act.

Shelf Registration Statements – WKSI Status

- Pursuant to the Final Rules, the term “Well-Known Seasoned Issuer” (“WKSI”) is defined so as to explicitly exclude a BDC.

Free Writing Prospectuses

- The Final Rules allow issuers other than BDCs greater freedom to use written materials in the securities offering process by permitting the use of a free writing prospectus.
- Under the Final Rules, WKSIs are allowed to make written offers, including electronic communications, other than through a statutory prospectus.

Prospectus Delivery

- The Final Rules eliminated the prospectus delivery requirements previously imposed on issuers and replaced it with an “access-equals-delivery” model.
- Rule 172 under the 1933 Act provides that a final prospectus would be deemed to precede or accompany a security for sale, or for delivery after sale, for purposes of satisfying Section 5(b)(2) of the 1933 Act so long as the final prospectus is filed with the SEC by the required filing date.
- Rule 172 specifically provides that BDCs may not rely on Rule 172. As a result, a prospectus meeting the requirements of Section 10(a) of the 1933 Act is required to be delivered to each investor in a registered BDC offering conducted at, or prior to, the earlier of delivery of a confirmation of sale or delivery of the securities.

Disclosure in a Turbulent Financial Market

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- Revisit Risk Factors
 - Impact of FAS 157
 - Debt Covenants
 - Performance of Portfolio Companies
- Disclosure Regarding Debt Financing Arrangement
- Disclosure Regarding 200% Asset Coverage
- Going Concern Disclosure
- Disclosure Regarding Continuous Offerings
- Consolidation Within the BDC Industry
 - Proxy Statement/ Prospectus
 - Post-Effective Amendment to Shelf Registration Statement