

# BDC ROUNDTABLE

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## Regulatory and Compliance Update

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# Overview

- Shelf Offerings Below NAV
- Asset Coverage Test
  - Section 18(e)
  - Including/Excluding Debt of Lower Tier Entities
- Recent No-Action Letters
- Recent Exemptive Applications and Orders
- SEC Examinations
- Current Tax Developments and Issues

# Shelf Offerings Below NAV

- Section 23(b) prohibits sales of shares below NAV except in certain limited circumstances
- Section 63 permits sales of shares below NAV if, among other things, stockholders approve the policy and practice of making sales of shares below NAV
- Notwithstanding stockholder approval to issue shares below NAV in accordance with Section 63, the SEC staff did not permit BDCs to issue shares off of a shelf registration statement below NAV

# Shelf Offerings Below NAV

- However, in early 2009, the SEC staff permitted shelf offerings below NAV if:
  - Significant new disclosure added to shelf registration statement
  - Undertaking to file post-effective amendment if the cumulative dilution to the BDC's NAV per share from offerings under the shelf registration statement exceeds 15%
  - Inclusion of new undertaking regarding going concern opinion and fundamental change in financial position of BDC

# Asset Coverage Test – Section 18(e)

- Exempts certain issuances of senior securities from 200% asset coverage test
- Such issuances of senior securities must be solely for refunding through payment, purchase, redemption, retirement, or exchange, any outstanding senior security of the BDC

## Asset Coverage Test – Including/Excluding Debt of Lower Tier Entities

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- When is it appropriate to include/exclude the debt of lower tier entities for purposes of the 200% asset coverage test?
- Percentage ownership test?
- Consolidation test?
- Non-recourse liability test?

# Recent No-Action Letters

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- American Capital, Limited – June 30, 2009
  - Section 18(a)(1)(B) relief
- Kohlberg Capital Corporation – March 12, 2009
  - Section 63 relief

# Recent Exemptive Applications and Orders

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- Section 23(c) relief
  - Main Street Capital – June 16, 2009
  - Triangle Capital – May 5, 2009
- RIC-related certification
  - Harris & Harris Group – June 9, 2009
- Sections 18(a), 55(a) and 61(a) relief
  - MCG Capital – October 28, 2008
- Pending applications
  - Co-investment relief – Ares Capital and Ridgewood Capital
  - Section 12(d)(3) relief – Allied Capital

# SEC Examinations

- No new news other than the SEC staff has continued to focus its resources on conducting BDC examinations
- As a result, if you have not received an SEC staff examination in the last couple of years, you should expect to receive one soon.
- “Madoff Effect”

## Current Tax Developments and Issues – Relaxation of Stock Distribution Rules

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- Generally, stock dividends are not taxable and do not give rise to dividends-paid deductions
- Exceptions exist for, *inter alia*, stock dividends in lieu of cash
- Affirmative use of exception allows RICs and REITs to retain cash, but obtain deductions
- Prior informal IRS position required at least 20% cash
- Rev. Proc. 2009-15 relaxed rule to allow as little as 10% cash, for taxable years ending on or before 12/31/09

## Current Tax Developments and Issues – Investments in PPIPs

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- PPIPs are partnerships between Treasury and private investors to hold certain mortgage-backed securities
- Rev. Proc. 2009-42 treats a RIC's interests in PPIPs as interests in the underlying securities if certain requirements are satisfied
  - Primary requirement is that 70% of the RIC's "original assets" are invested in PPIPs
- Implication of revenue procedure?

# Current Tax Developments and Issues – Deferral and Nature of COD Income

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- Section 108(i) allows a taxpayer to elect to defer the realization of COD income as the result of a reacquisition of a debt instrument at a discounted price
  - Election is instrument by instrument
  - Deferred income is includible in income ratably over a 5-year period, beginning with the fourth (2009) or fifth (2010) year after the acquisition year
  - Rule applies to acquisitions after 12/31/08 and before 1/1/11
  - RICs must increase their E&P in year of realization, not the later years
- Rule is potentially particularly advantageous to RICs because of “good income” issue and uncertain nature of COD income for RIC purposes
  - Guidance requested, but not yet received, from IRS

# Current Tax Developments and Issues – Debt Losses

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- **Bad debt losses**
  - **Wholly worthless**
    - Difficult to pinpoint correct year
  - **Partially worthless**
    - Book charge-off in year required
  - **No bad debt loss for “securities”**
    - Registered-form issue
- **Worthless securities losses/exchange losses**
  - **Same issue as above with regard to “worthlessness”**
    - Preferable to have realization event
  - **Capital v. ordinary**
    - Burbank; FNMA
    - Nature of acquisition and status of RIC at that time
  - **“Election”**
    - Risk of locking in position