

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

Publicly Traded Private Equity Review

JUNE 2008

VOL. 1, NO. 1

Upcoming Events

BDC Roundtable
September 9-10, 2008

In This Issue

The Securities and Exchange Commission Expands Eligible Investments for Business Development Companies

Considerations for BDCs Trading Below NAV

BDC Securities Offering Reform

SPACs Set Their Sights on Asset Management Firms

Upcoming BDC Roundtable

The Securities and Exchange Commission Expands Eligible Investments for Business Development Companies

The Securities and Exchange Commission (“SEC”) recently amended the definition of “eligible portfolio company” under Rule 2a-46 of the Investment Company Act of 1940 (“1940 Act”) to allow business development companies (“BDCs”) greater flexibility to invest in public companies.¹ This amendment to the definition of eligible portfolio company, effective July 21, 2008, expands the universe of eligible portfolio companies for BDCs to domestic operating companies with securities listed on a national securities exchange so long as the company has a market capitalization of less than \$250 million, computed as of any date in the 60-day period prior to the BDC’s acquisition of the company’s securities.

Background

The Small Business Investment Incentive Act of 1980 added to the 1940 Act a new category of closed-end investment company known as a BDC. In general, BDCs are publicly

traded closed-end funds that make investments in private or thinly traded public companies in the form of long-term debt or equity capital, with the goal of generating capital appreciation and/or current income. In establishing BDCs under the 1940 Act, Congress was hoping to encourage the finance community to establish public vehicles for investing in private equity to increase the flow of capital to small, growing private and public companies.

In general, BDCs must have at least 70 percent of their total assets invested in “eligible portfolio companies” at the time they make any new investment in a portfolio company (the “70 percent basket”). The 1940 Act initially defined “eligible portfolio company” to generally include domestic operating companies that, among other things, did not have any class of securities that were “marginable” under rules promulgated by the Federal Reserve Board (the “Fed”). Since that definition was enacted, however, the Fed modified its definition of marginable securities on a number of occasions. These modifications had the unintended consequence of expanding the definition of “marginable securities.”

On October 25, 2006, the SEC addressed the consequences of the expansion of the definition of marginable securities by adopting two new rules under the 1940 Act, Rules 2a-46 and 55a-1. These rules clarified that private companies, and certain public companies, are eligible investments for BDCs

© 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

regardless of whether they issue marginable securities.² On the same day, the SEC also re-proposed for comment Rule 2a-46(b).³ As now adopted, this rule permits BDCs to include the securities of certain public companies whose securities are traded on a national securities exchange in their 70 percent baskets.

Rule 2a-46(b)

On May 15, 2008, the SEC adopted Rule 2a-46(b). Rule 2a-46(b) expands the definition of eligible portfolio company to include any domestic operating company that has a class of securities listed on a national exchange that has a market capitalization of less than \$250 million on any day in the 60-day period immediately before the BDC's acquisition of its securities. For purposes of Rule 2a-46(b), a company's market capitalization is the aggregate market value of its outstanding voting and non-voting common equity securities. Market capitalization is calculated using the price at which the company's common equity is last sold, or the average of the bid and asked prices of the company's common equity, in the principal market for such common equity.

This final rule culminates a process that was spearheaded by Sutherland and others in the BDC community since they initially engaged the SEC in discussions almost seven years ago.

¹ See Definition of Eligible Portfolio Company under the Investment Company Act of 1940, SEC Investment Company Act Release No. 28266 (May 15, 2008). The final rule release may also be found on the SEC's Web site using the following link: <http://sec.gov/rules/final/2008/ic-28266.pdf>. The items discussed above are only a summary of the release. We urge you to read the release in its entirety.

² See Definition of Eligible Portfolio Company, SEC Investment Company Act Release No. 27538 (Oct. 25, 2006) (hereinafter "Final Rule Release"); see also Steven B. Boehm, Cynthia M. Krus, Harry S. Pangas and Lisa A. Morgan, *Shedding New Light on Business Development Companies*, INVESTMENT LAW, Oct. 2004, at 15 (Discussing the impact the uncertainty of the definition of marginable securities had on BDCs' ability to include certain portfolio companies in their 70 percent baskets).

³ See Definition of Eligible Portfolio Company, SEC Investment Company Act Release No. 27539 (Oct. 25, 2006) (hereinafter "Rule Reproposal Release"). The Rule Reproposal Release proposed three alternative measures for including public companies within the definition of eligible portfolio company: Companies with a public float of less than \$75 million; a market capitalization of less than \$150 million; or a market capitalization of less than \$250 million. This reproposal was in response to concern many BDCs expressed with Rule 2a-46(b) as originally proposed in 2004, which defined eligible portfolio companies as public companies listed on a national exchange but in danger of de-listing for failure to maintain eligibility requirements. In essence, Rule 2a-46(b) aimed to include financially troubled issuers within the definition of eligible portfolio companies. The Rule Reproposal Release responded to BDCs' concerns by proposing to expand the definition of eligible portfolio company to include certain public domestic operating companies.

Considerations for BDCs Trading Below NAV

Under the 1940 Act, a BDC is generally restricted in its ability to issue common stock at a price below its net asset value ("NAV") per share. Given recent market volatility, many BDCs have found their common stock trading at or below NAV. In these situations, here are some issues BDCs should consider:

Effect on Dividend Reinvestment Plans

Under a dividend reinvestment plan, cash dividends payable on a participating shareholder's common stock are automatically reinvested in newly issued shares. A BDC's board should consider whether or not the terms of the dividend reinvestment plan permit the issuance of shares below NAV. In some situations, purchases in the open market may be more appropriate than the issuance of new shares given the dilution attributable to such an issuance.

Impact on Compensation Plans

Internally managed BDCs are permitted, in certain instances, to issue warrants, options and rights to purchase shares of a company's stocks to their directors, officers, employees and general partners pursuant to executive compensation plans. When common stock is trading at or below NAV, however, a BDC may be limited in its ability to issue securities, including restricted stock, pursuant to such a compensation plan as a result of the terms of the applicable plan.

Considerations Regarding Proxy Statements

In order to issue or sell shares below NAV, a BDC's shareholders must typically approve the policy and practice of making such issuances or sales at an annual or special meeting within one year immediately prior to any such issuance or sale. Consequently, if a BDC anticipates a need to issue or sell shares below NAV in a given year, it should consider whether to insert a proposal in its proxy materials to obtain shareholder approval of such issuances or sales.

Use of Rights Offerings

Another way a BDC can raise equity when its common stock is trading below NAV is through a rights offering. There are generally two types of rights offerings – transferable and non-transferable. In both cases, rights are issued pro rata to a BDC's existing shareholders. A transferable rights offering permits the subsequent sale of such rights in the open market. In exchange for this flexibility, the SEC has taken the position that no more than one additional share may be issued for each three shares currently outstanding in connection with a transferable rights offering below NAV. Non-transferable rights offerings are not subject to the same limitation, given the reduced concern regarding dilution in the non-transferable context. To date, five BDCs have completed transferable rights offerings in 2008.

BDC Securities Offering Reform

Sutherland was contacted by the Staff of the Division of Investment Management of the SEC and the Investment Company Institute (the "ICI") regarding an upcoming disclosure reform initiative for BDCs. Sutherland drafted and submitted the proposed rulemaking discussed below and intends to meet with the staff of the SEC regarding the proposal in the near future.

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.¹ The Amendments are intended to recognize that BDCs are subject to all of the disclosure and filing requirements under the Securities and 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 that BDCs conduct registered offerings under the Securities Act of 1933 (the "1933 Act") in the same manner as other 1934 Act Registrants that file registration statements on Forms S-1 or S-3. As a result, the Amendments would subject BDCs to the same requirements and would offer to them the same benefits that other 1934 Act Registrants enjoy under the Securities Offering Reform Final Rules (the "Final Rules"). The Amendments address certain limitations placed on BDCs trying to access the public capital markets, including, among others:

¹ Securities Offering Reform, Release Nos. 33-8591; 34-52056; IC-26993; FR-75, International Securities Release No. 1294 (August 3, 2005) [70 FR 44722 (Aug. 3, 2005)] ("Securities Offering Reform Final Rules").

- Shelf Registration Statements
 - Incorporation by Reference
 - The shelf registration process entails a number of practical difficulties for a BDC. For example, 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.
 - Well-Known Seasoned Issuer Status
 - Pursuant to the Final Rules, the term “Well-Known Seasoned Issuer” (“WKSI”) is defined so as to explicitly exclude a BDC. Thus, BDCs may not take advantage of the liberalized rules relating to communications with investors and the registration process generally.
- 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. Because BDCs are excluded from the definition of WKSI under the Final Rules, BDCs are not able to use free-writing prospectuses in the same manner as other 1934 Act Registrants.
- 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.

SPACs Set Their Sights on Asset Management Firms

During the past two years, promoters associated with private equity and hedge fund firms have increasingly raised money in the public market through Special Purpose Acquisition Companies, or SPACs. SPACs, which are essentially publicly traded shell companies, raise capital through an initial public offering without having a specific target acquisition in place. Instead, at the time of the initial public offering, SPACs make a commitment to acquire one or more operating businesses within a specified time period.

Recently, SPACs have begun to target asset management firms, including hedge funds and other alternative asset management firms, as prospective acquisitions. For example, Freedom Acquisition recently took public a London-based hedge fund manager, GLG Partners, in a transaction valued at \$3.4 billion. By acquiring an equity interest in a hedge fund or other alternative asset management firm, a SPAC receives a portion of the asset manager’s profits. A SPAC will not typically acquire or merge with a target fund directly. Rather, a SPAC will generally obtain an equity stake in an asset management firm that provides advisory services to one or more target funds.

Although acquiring such an equity stake in an asset management firm can lead to an attractive profit-sharing arrangement, it also poses potential regulatory concerns for SPACs. The asset management

industry is subject to extensive regulation by the SEC. A SPAC that acquires an asset management firm may therefore become subject to the regulatory restrictions of the 1934 Act, and the Investment Advisers Act of 1940. If the asset management firm has an international business, there may be additional foreign securities law restrictions as well.

Despite these regulatory restrictions, however, SPACs are likely to remain an attractive option for established asset management firms seeking liquidity and access to the public markets.

Upcoming BDC Roundtable

Sutherland will be hosting the second annual BDC Roundtable on September 9-10, 2008. If you would like more information or wish to attend the Roundtable, please contact Sutherland at sutherlandbdcgroup@sutherland.com.

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
Owen J. Pinkerton	202.383.0254	owen.pinkerton@sutherland.com
Carol W. Khalil	202.383.0596	carol.khalil@sutherland.com
Hannah L. Friedberg	212.389.5085	hannah.friedberg@sutherland.com
Anne W. Gray	202.383.0966	anne.gray@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 Lisa Morgan at lisa.morgan@sutherland.com.