

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

## Publicly Traded Private Equity Review

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September 9-10, 2008

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### The Securities and Exchange Commission Ramps Up Inspections of BDCs

The Securities and Exchange Commission's Office of Compliance Inspections and Examinations ("OCIE") has begun to focus its inspection program on business development companies ("BDCs"). Previously, it was a rare event for a BDC to be examined by OCIE. However, over the last several months, a number of BDCs have been inspected or notified of an impending inspection by OCIE. Although it is not clear what piqued OCIE's interest in BDCs, it may be something as simple as the significant growth in the BDC industry over the last several years. Whatever the cause, it is likely that BDC inspections will become more commonplace than in the past.

The SEC's authority to examine BDCs emanates from the Investment Company Act of 1940, which mandates that BDCs keep records relating to, among other things, their financial statements and also authorizes the SEC to conduct examinations and to require that BDCs, their affiliates and their auditors provide copies of these records to the SEC. Similarly, the Investment Advisers Act of 1940 authorizes the

SEC to require investment advisers to BDCs to keep specific books and records and to conduct examinations of advisers.

Although it is not required to do so, OCIE typically provides BDCs with advance notice of an examination. Such advance notice is generally in the form of a letter or a phone call from a member of the OCIE staff informing the BDC that OCIE will be conducting an inspection of the BDC and, to the extent applicable, its investment adviser. OCIE will then provide the BDC with a list of items that the members of the OCIE staff will expect to be provided to them during their on-site visit. The items requested will generally not be limited to the records and documents required to be maintained by the Investment Company Act or the Advisers Act, but will also include items that OCIE will request be voluntarily produced, such as documents prepared for other regulatory purposes, e-mails and press releases. As a result, BDCs should establish procedures that allow them to designate the items that need to be provided to the OCIE staff and assemble all requested items in preparation for OCIE's inspection.

Upon arriving at the BDC's offices, the members of the OCIE staff will initially conduct an interview with the BDC's chief compliance officer and other members of management in order to better understand the BDC's business and its compliance processes and procedures. Following the interview, the OCIE staff members will expect that the requested records and documents will be available for their inspection. On average, the OCIE staff members will be in the BDC's offices for one to two weeks reviewing such items

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as well as refining their requests and/or conducting additional interviews. The OCIE staff members will also want to take a copy of many of the requested items with them after the completion of their on-site visit.

At the completion of the on-site portion of the examination, the members of OCIE's staff will conduct an exit interview with the BDC's chief compliance officer and other members of management. During this interview, it is possible that OCIE staff members will identify areas of concern so that the BDC and its investment adviser can begin taking remedial action. To the extent possible, it is generally advisable to have legal counsel present during the interviews.

Within 120 days of the completion of the on-site visit, the BDC and its investment adviser should be sent a written notification from OCIE that will generally take one of two forms: (1) the OCIE staff members may send the BDC and/or its investment adviser a letter indicating that the examination has concluded without findings (often referred to as a "no further action letter") or (2) the OCIE staff members may send the BDC and/or its investment adviser a letter that describes issues identified, asks them to undertake corrective action and to provide the OCIE staff members with a written response outlining those actions, and possibly requests a conference at the SEC's offices (often referred to as a "deficiency letter"). If serious problems are found, in addition to sending a deficiency letter, the OCIE staff members may refer the matter to the SEC's Division of Enforcement.

Some of the areas that the members of OCIE's staff are likely to focus on during their inspections of BDCs include:

- Personal trading of access persons consistent with codes of ethics adopted under the Investment Company Act or the Advisers Act
- Processes and procedures for determining the fair value of securities without readily available market values
- Policies and procedures for making investment decisions and managing portfolio companies
- Disclosure controls and procedures and internal control over financial reporting
- Policies and procedures to prohibit the entry into transactions with affiliated persons or entities
- Proper administration of equity incentive compensation plans for internally managed BDCs
- Proper calculation and payment of management and incentive compensation fees paid to the investment advisers of externally managed BDCs

It has been our experience that due to the limited number of BDCs, many examiners are not familiar with the BDC model, which may result in a learning process. BDCs and their investment advisers may want to engage in a model examination to be as prepared as possible for an OCIE exam. The best result in exams is a result of cooperation with examiners.

## 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 has met with the staff of the SEC regarding the proposal. The staff of the SEC is currently assessing the proposal.*

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. 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:

- 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, WKSI 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.

## SEC Expected to Issue Fair Value Guidance

The Securities and Exchange Commission (“SEC”) is currently in the process of formulating fair valuation guidance, which is expected to be released very soon. Such guidance has been necessary for some time. The SEC’s guidance is expected to more specifically address the valuation of a wide range of instruments including equities, bonds, derivatives and illiquid and restricted securities. Such guidance will aim to provide fund managers with greater clarity and structure in determining fair value.

## The NYSE and NASDAQ Open Their Doors to SPACs

On July 25, 2008, the Securities and Exchange Commission (“SEC”) approved a proposed rule change to allow the listing of special purpose acquisition companies (“SPACs”) on the NASDAQ Stock Market LLC (“NASDAQ”) subject to certain requirements. On May 6, 2008, the SEC approved a similar listing proposal submitted by the New York Stock Exchange (“NYSE”). The initial public offering (“IPO”) of Navios Maritime Acquisition Corp. (“NNAU”) on June 26, 2008, which raised \$220 million, was the first SPAC IPO on the NYSE since the adoption of the proposal.

SPACs are companies without business operations that have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies. SPACs raise capital through IPOs in the public markets. SPACs do not identify their targets in the business plan during the IPO. When a SPAC identifies a specific business combination that it wishes to enter into, it must generally obtain approval from shareholders. Historically, the lack of business operations raised concerns in earlier SPAC IPOs. However, recent SPAC offerings have included significant investor protections and, thus, NASDAQ and NYSE have changed their policies against the listing of SPACs.

Previously, SPACs only traded on the OTC Bulletin Board and on the American Stock Exchange (“Amex”). The Amex requires that SPACs have a minimum market capitalization of \$50 million and a minimum public float. Amex’s rules are qualitative in nature, focusing on the history of management and the sponsor without mandating any minimum revenue or operating profit.

The NASDAQ and NYSE proposals, however, are more rules-oriented and are based on generally accepted market practices. Specifically, in addition to complying with pre-existing NASDAQ and NYSE listing rules, both proposals impose on SPACs a time frame for the business combination after the effectiveness of its IPO registration statement; the requirement to place the IPO funds in an escrow or trust account; the requirement to obtain shareholder approval before entering into a business combination; and cash out dissent limits. Both proposals also have larger capitalization requirements than that of the Amex. However, the NYSE requirements are more specific than those of NASDAQ.

The NASDAQ approving release can be accessed at: <http://www.sec.gov/rules/sro/nasdaq/2008/34-58228.pdf>.

The NYSE approving release can be accessed at: <http://www.sec.gov/rules/sro/nyse/2008/34-57785.pdf>.

## 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](mailto: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.

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For more information about the publicly traded private equity space, please visit Sutherland's Web site, [www.publiclytradedprivateequity.com](http://www.publiclytradedprivateequity.com).

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