

Inside Track with Broc:

Harry S. Pangas on Business Development Companies (7/7/08)

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Broc: I have seen an increasing number of articles about business development companies or BDCs over the last couple of years. What are BDCs?

Harry: A BDC is a type of closed-end investment company that invests in securities issued by private U.S. companies or public U.S. companies with market capitalizations of less than \$250 million. I think that the best way to describe a BDC is to think of a private equity or venture capital fund that offers and sells its shares to the public. Some well-known BDCs include Allied Capital Corporation, American Capital Strategies, Ltd., Ares Capital Corporation, Apollo Investment Corporation and BlackRock Kelso Capital Corporation.

Broc: I know that you and your firm have represented BDCs for many years and yet up until relatively recently I do not remember seeing much of anything about BDCs. Why have BDCs become so much more visible over the last couple of years?

Harry: BDCs have been around since 1980, but it wasn't until 2004 that they started to get the attention of Wall Street and the mainstream media. In 2004, Apollo Management, L.P., the well-known New York private equity firm led by Leon Black, took a BDC by the name of Apollo Investment Corporation public in a \$930 million IPO.

Soon after Apollo Investment's successful IPO, more than a dozen private equity firms, including Kohlberg Kravis Roberts & Co. and Thomas H. Lee Partners, tried to take a BDC public. The fact that these brand-name private equity firms tried to IPO a BDC captured the attention of Wall Street and the press. In the end, only a couple of BDCs managed to successfully complete IPOs in 2004, but ever since then Wall Street and the investing public have become more familiar with BDCs.

Broc: Why were all of these private equity firms so interested in forming a BDC?

Harry: I think that the ease by which Apollo Investment was able to raise close to \$1 billion was one of the main motivating factors behind the desire of these private equity firms to form a BDC. Typically, the managers of private equity firms have to travel around the world meeting, soliciting and negotiating with institutional investors in order to form a private equity fund. This is both a long and arduous process for the private equity managers. A BDC allows them to avoid this process.

Also, there are a number of structural advantages that BDCs have over private equity funds that make them attractive to private equity fund managers. These advantages include:

- a permanent source of capital as opposed to the standard periodic capital return requirements of private equity firms; and
- ability to use publicly traded stock to incentivize employees and as a currency to consummate investments/acquisitions.

Origin of BDCs

Broc: I know that you said BDCs were created in 1980, but can you provide some more color surrounding their creation?

Harry: Sure. BDCs were created by Congress in 1980 through the enactment of the Small Business Investment Incentive Act of 1980, which amended the Investment Company Act of 1940 to provide for a specific set of rules that

only apply to BDCs. The 1980 Act was designed to encourage the flow of capital to small and growing businesses by putting in place a workable approach to the regulation of a public vehicle investing in private equity.

Broc: What do you mean by a "workable approach"?

Harry: In order to understand what I mean by a "workable approach," I'll need to provide a quick overview of the Investment Company Act of 1940. In general, a company that is engaged primarily in the business of investing in the securities of other companies, such as private equity and venture capital firms, must register with the SEC under, and become subject to the provisions of, the 1940 Act, unless such company falls within an exemption under the 1940 Act.

Now, unlike the Securities Act of 1933 and the Securities Exchange Act of 1934, the 1940 Act contains numerous substantive regulatory requirements pertaining to an investment company's operations. Many private equity and venture capital firms believed that these substantive provisions made it impracticable for them to register under, or become subject to, the 1940 Act. As a result, these private equity and venture capital firms structured their funds to ensure the availability of an exemption from the 1940 Act, typically either the one for a fund with 100 or fewer investors or the one for a fund with investors who are all "qualified purchasers." So when I said that the 1980 Act put in place a "workable approach" to the regulation of a public vehicle investing in private equity, I am referring to the fact that the 1980 Act attempted to eliminate the application of certain provisions of the 1940 Act that created unnecessary disincentives to the formation of a "publicly-held, private equity fund."

Broc: How did the 1980 Act attempt to accomplish this goal?

Harry: The 1980 Act attempted to do this through the creation of a new type of company subject to regulation under the 1940 Act – the business development company. Essentially, the 1980 Act fashioned a regulatory framework for BDCs from the core provisions of the 1940 Act. Those provisions of the 1940 Act that impeded, as a practical matter, the formation of a "publicly-held, private equity fund" were either not made applicable to BDCs or altered in a manner more consistent with how private equity or venture capital firms operate their businesses.

Broc: Has the 1980 Act been successful in encouraging the formation of "publicly-held, private equity funds"?

Harry: Yes, although I think that there was an expectation that there would be a flood of private equity and venture capital firms seeking to form BDCs immediately after the enactment of the 1980 Act, which never happened. On the other hand, there has been an ever-increasing interest in BDCs over the last four to five years and that interest shows no signs of abating.

Broc: How many BDCs are there today?

Harry: There are approximately 30 actively-traded BDCs and that is not including the three or four entities that are currently seeking to become BDCs through recently filed IPOs.

Broc: Speaking of IPOs, I saw that Fifth Street Finance Corp. priced and closed its BDC IPO a couple of weeks ago, which is pretty incredible given the market that we are in.

Harry: We are very happy that we were able to be a part of their IPO. Not only was the IPO remarkable given the current market conditions, but it was also the first BDC offering underwritten by Goldman Sachs. Hopefully, Goldman will become more active in the BDC space.

Broc: I know that some of the BDC IPOs on file at the SEC are Small Business Investment Companies or SBICs that are seeking to become BDCs in connection with an IPO. What can you tell us about that?

Harry: Essentially, the same structural advantages of BDCs over traditional private equity funds that we previously discussed make them attractive to SBIC managers. The interesting twist about these BDC IPOs is that the SBICs merge with and into a wholly owned subsidiary of the newly formed BDC (as opposed to with and into the BDC) so that the BDC, through its SBIC subsidiary, can issue debentures guaranteed by the Small Business Administration subsequent to the IPO. The obvious advantage of having the ability to issue SBA-guaranteed debentures is that such debentures carry long-term fixed interest rates that are generally lower than interest rates on comparable bank and

public debt. So far, two SBICs have completed BDC IPOs. Main Street Capital Corporation raised \$60 million in its IPO, while Triangle Capital Corporation raised \$63 million.

1940 Act Regulatory Structure

Broc: How does a company become a BDC?

Harry: To become a BDC, a company must file a notice on a Form N-54A with the SEC indicating that it elects to be regulated as a BDC under the 1940 Act. To make the BDC election, a company must also have a class of its equity securities registered under the Securities Exchange Act of 1934. As a result, BDCs must file Form 10-Ks, 10-Qs and 8-Ks with the SEC and are subject to the proxy solicitation requirements of Section 14 of the 1934 Act.

Broc: Are BDCs subject to restrictions on the type of investments that they may make?

Harry: Yes, a BDC is generally required to have at least 70% of its assets invested in the securities of private U.S. companies and public U.S. companies with market capitalizations of less than \$250 million. Such assets are referred to as "good BDC assets."

Broc: So, I guess a BDC can invest the remaining 30% of its assets in whatever else it deems to be appropriate, such as Microsoft stock?

Harry: In theory, yes. However, we have had conversations with the SEC staff and I think it is fair to say that they may have a different opinion. Although the full answer to your question is too complicated to discuss here, if any of your listeners are faced with this issue I think that we can provide plenty of good insight into the SEC staff's position on this matter.

Broc: Are there any other substantive regulatory requirements placed on a BDC's operations under the 1940 Act?

Harry: Yes, the 1940 Act places numerous regulatory requirements on a BDC's operations. However, I think that many investors will find that these regulatory requirements make BDCs attractive investments in that they provide for good corporate governance. Some of these regulatory requirements include:

- restrictions on the amount of debt a BDC may have outstanding at any one time;
- restrictions on the ability of a BDC to enter into transactions with certain persons related to the BDC, including officers, directors, employees, any investment adviser and other persons controlling or under common control with the BDC, absent an SEC exemptive order;
- prohibitions against a BDC protecting any of its directors, officers or investment adviser against any liability to the BDC, or its stockholders, arising from willful misfeasance, bad faith, gross negligence or reckless disregard of their duties to the BDC;
- a requirement that a BDC institute procedures reasonably necessary to prohibit personal investment activities that may involve conflicts of interest between a BDC and its employees or its external adviser and its employees;
- a requirement that a BDC adopt and implement policies and procedures designed to prevent violation of the federal securities laws and appoint a chief compliance officer to administer the compliance policies and procedures;
- for internally-managed BDCs, limitations and, in certain circumstances, prohibitions (absent SEC relief) on the issuance of equity incentive compensation to officers, directors and employees; and
- for externally-managed BDCs with the standard "2 and 20" incentive fee arrangement, a prohibition on the issuance of equity incentive compensation to the investment adviser and its officers, directors and employees.

Broc: It seems like there are a lot of restrictions on a BDC's operations under the 1940 Act. I thought you said that the 1980 Act amended the 1940 Act to eliminate some of the more onerous provisions of the 1940 Act to encourage private equity and venture capital funds to subject themselves to regulation under the 1940 Act.

Harry: Believe it or not, the alternative to a BDC under the 1940 Act, which is a registered closed-end fund, is much

more restrictive than BDC. So, if a private equity or venture capital fund wants to access the public markets for capital, the BDC is really the only way to go.

Broc: Can you briefly describe the difference between an internally-managed and externally-managed BDC and touch upon the "2 and 20" incentive fee arrangement you mentioned?

Harry: Sure. BDCs may be operated as internally managed investment companies or externally managed investment companies. Internally managed BDCs manage their investment operations in-house (i.e., they hire their own employees), while externally managed BDCs generally do not have any employees and "outsource" the management of their investment operations to external investment managers and other service providers.

A typical external investment manager will charge fees of "2 and 20" for providing investment management services to an externally managed BDC, which refers to a management fee of 2% of the BDC's gross assets per annum and a performance fee of 20% of the BDC's net investment income, often subject to a hurdle or preferred return, and capital gains.

Current Issues Facing BDCs

Broc: Is there anything new in the BDC space that you think would be of interest to our listeners?

Harry: Yes, there are a few new events/issues facing BDC that are worth mentioning.

First, the SEC approved a new rule in May 2008 that expanded the definition of "good BDC assets" to include any investment in a domestic operating company that has a class of securities listed on an exchange and that has a market capitalization of less than \$250 million. Previously, investments in companies with exchanged-listed securities were considered "bad BDC assets."

Second, the SEC's Office of Compliance Inspections and Examinations or "OCIE" has begun to increase its focus on examining BDCs. Previously, BDCs seemed to be below OCIE's radar screen, but that has seemed to change recently. In this regard, it is important to remember that because BDCs are subject to regulation under the 1940 Act, they are subject to periodic or special examinations by OCIE. As a result, BDCs shouldn't be surprised if they receive a letter from OCIE notifying them of an impending examination.

Third, given the current market conditions, a large number of BDCs have seen their shares of common stock trade below the per share net asset value (or book value) of such shares. Because the 1940 Act prohibits BDCs from issuing shares of their common stock below the per share net asset value (subject to certain exceptions which I will discuss), BDCs have had to alter the way they raise capital in the current market. Two exceptions to such prohibition are issuing shares of common stock pursuant to a rights offering to existing stockholders or receiving stockholder approval to issue shares of common stock at a price below the per share net asset value of such stock. As a result, there has been a considerable uptick in the number of BDCs conducting rights offerings and seeking stockholder approval to issue shares of their common stock at a price below the per share net asset value of such shares.

Broc: Well, it looks like we are running out of time, so I would like to thank you for giving us a primer on BDCs.

Harry: My pleasure. Hope to do it again sometime.