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Spending Legislation Contains Long-Awaited Reforms for BDCs

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On March 23, 2018, Congress passed and President Trump signed the Consolidated Appropriations Act of 2018, the omnibus spending bill to fund the federal government through September. The spending bill included the Small Business Credit Availability Act (the "SBCAA"), which relaxes leverage and offering restrictions that many business development companies ("BDCs") have been seeking over the last several years.

The SBCAA amends the Investment Company Act of 1940, as amended (the "1940 Act") to permit a BDC to double the amount of leverage the BDC may utilize. It does so by reducing a BDC's required asset coverage[1] from 200% to 150%, subject to certain initial approval and ongoing reporting requirements. The SBCAA also will meaningfully change how BDCs are operated and offered to investors, as it requires the Securities and Exchange Commission ("SEC") to streamline the offering, filing and registration processes for BDCs to more closely mirror those available to non-investment company issuers.[2]

Reduction in Asset Coverage; Approval and Reporting Requirements

Under Section 61(a) of the 1940 Act, a BDC generally is required to maintain asset coverage of 200% for senior securities representing indebtedness (*i.e.*, debt) or stock (*i.e.*, preferred stock). Put simply, under prior law, a BDC with $100 in equity could borrow up to $100 (equaling $200 in total assets). The SBCAA amended Section 61(a) to add provisions permitting a BDC to reduce its asset coverage from 200% to 150%. As a result, a BDC with $100 in equity will now be able to borrow up to $200 (equaling $300 in total assets), effectively doubling its leverage.[3]

Importantly, this increase in permissible leverage is not automatic. To reduce its asset coverage from 200% to 150%, and thereby increase its leverage, a BDC must comply with a series of conditions, including:

- initial approval by the BDC's board of directors or its shareholders, and public disclosure of such approval, within five business days of receipt; and

- ongoing disclosure in the BDC's periodic reports with respect to the approval obtained by the BDC, the amount of leverage incurred by the BDC, the BDC's asset coverage and the principal risks associated with the BDC's leverage.[4]

Approval Process

A BDC can reduce its statutory asset coverage either through approval by its board of directors ***or*** its shareholders—it does not need both. If approval of a BDC's board of directors is sought, that approval must be by a "required majority" of the BDC's board of directors (essentially, a majority of the independent directors).[5] If approval of a BDC's shareholders is sought, the BDC will need to hold a special meeting to solicit shareholder approval (or time such approval to coincide with its annual meeting) and will need, assuming a quorum is present at the meeting, the favorable vote of more than 50% of the votes cast on the proposal.[6]

Under the SBCAA amendments, a BDC that obtains board approval cannot increase its leverage until ***one year after*** the approval date. A BDC that obtains shareholder approval, however, will be able to increase its leverage ***the day after*** such approval is obtained.[7] Either way, a BDC will need to disclose the approval of the reduction in required asset coverage no later than five business days after such approval is obtained. The required disclosure would be done through a current report filing on Form 8-K (or other annual or quarterly report) by the BDC **and** a notice posted on the BDC's website. [8]

Ongoing Reporting Requirements

If a BDC obtains approval to reduce its asset coverage to 150%, the BDC also will be subject to ongoing disclosure obligations with respect to its leverage arrangements. A BDC will be required, in each of its periodic filings under the Securities Exchange Act of 1934, as amended (the "1934 Act"), to disclose:

- the aggregate outstanding principal amount of debt incurred by the BDC (or liquidation preference of preferred stock if a BDC is leveraged in that manner) and the BDC's asset coverage percentage as of the BDC's most recent financial statements included in that filing;
- that the BDC has obtained the necessary board or shareholder approval, and the effective date of such approval;

- the amount of senior securities, and the associated asset coverage ratios, of the BDC determined as of the date of the most recent financial statements of the BDC included in that filing; and
- the principal risk factors associated with such senior securities.[9]

Special Requirements for Non-Traded BDCs

The SBCAA also amends Section 61(a) of the 1940 Act to include a liquidity condition for BDCs that do not have their common shares listed on a national securities exchange (commonly referred to as "non-traded BDCs"), but wish to reduce their asset coverage and increase their leverage. A non-traded BDC that obtains approval to reduce its asset coverage to 150% will be required to offer its shareholders the opportunity to sell their shares over the next year following the calendar quarter in which the approval was obtained.[10]

One method for share repurchases, specifically noted in the SBCAA amendments, is for the BDC to conduct quarterly issuer tender offers, each for 25% of its shares, over the next year. Notably, there is no stated requirement as to the price at which a BDC must offer to repurchase its shares. Most non-traded BDCs that currently conduct tender offers do so at, or close to, net asset value.

Registration and Regulatory Parity

The SBCAA also directs the SEC, over the next year, to amend a number of rules and forms to allow BDCs to avail themselves of securities offering related accommodations and proxy rules available to other non-investment company issuers that file reports under Section 13 or Section 15(d) of the 1934 Act. BDCs and registered investments companies, including traditional closed-end funds, were excluded from relying on those accommodative rules when they were adopted by the SEC in 2005.[11]

With respect to securities offerings and market communications, BDCs will now be eligible to be included in the definition of a "well-known seasoned issuer" (or "WKSI") and will be able to file automatic shelf registration statements to expedite their securities offering process.[12] BDCs also will be permitted to rely on the safe-harbor provisions of the 1933 Act and release factual and forward-looking business information without running afoul of the statute's gun-jumping provisions.[13]

BDCs that qualify as WKSIs also will be able to rely on the "free writing prospectus" rules under the 1933 Act, which also should facilitate market communications, as those BDCs will be able to communicate information that otherwise may not be included in their Form N-2 registration statements (the form of registration statement used by BDCs) and also will have the benefit of a safe harbor for immaterial and unintentional violations of applicable gun-jumping provisions.[14]

Another benefit of the required rule amendments relates to the prospectus delivery requirements applicable to BDCs. Rules 172 and 173 under the 1933 Act generally (i) exempt non-investment company issuers and underwriters or dealers from delivering a prospectus in connection with an offering so long as the final prospectus is filed with the SEC and (ii) permit underwriters or dealers to deliver a notice of sale within two business days of the completion of such sale in lieu of delivering a final prospectus. Although registered investment companies cannot avail themselves of the rule amendments, BDCs will now be able to rely on these rules, which should materially reduce the time and costs associated with prospectus delivery in connection with their registered offerings.

The SBCAA also requires the SEC to revise Form N-2 to permit a BDC that would otherwise meet the requirements of Form S-3 to incorporate by reference its publicly filed periodic reports into the BDC's registration statement. This should allow BDCs to reduce the amount of time they are in registration with the SEC, reduce the length of their offering materials and be in a position to raise capital more quickly (and perhaps more cost effectively) in varying market conditions. The SEC also was directed to amend Rule 497 under the 1933 Act to permit BDCs to file form prospectus supplements in the same manner in which non-investment company issuers file such supplements under Rule 424(b). This rule change should reduce the filing burden on BDCs and align their prospectus filing obligations with other market competitors.

Similar to the SBCAA's direction to the SEC to implement the 1933 Act rule amendments, the SBCAA directs the SEC to amend certain rules under the 1934 Act, which will permit BDCs to incorporate previously filed financial statements into their proxy materials under Schedule 14A similar to issuers registered on Form S-3. The SEC also was directed to amend Regulation F-D to avoid invalidating a Form N-2 registration statement filed by a BDC if a BDC inadvertently failed to disclose material information under the rules.

Finally, the SBCAA provides that if the SEC does not complete the required rule and form amendments within a year following the date of the enactment of the SBCAA, a BDC may deem those required amendments as having been completed in accordance with the actions required of the SEC under the SBCAA.

Action Items

As noted above, neither the reduced asset coverage requirement nor the offering reform amendments are automatically effective. BDCs will require board or shareholder approval on the asset coverage front and will require SEC rulemaking (or some patience) on offering reform. That does not mean, however, that there are not a number of issues that BDCs, their sponsors and their boards should start considering in the near-term.

- *Approval process for asset coverage reduction*. In light of the different approval approaches, BDCs, their sponsors and boards will need to assess which approach is preferable, and not all BDCs may arrive at the same decision. Factors that may need to be considered include a BDC's shareholder base, costs and timing associated with increasing leverage, timing of the BDC's next annual shareholder meeting, current portfolio holdings, other leverage arrangements and shareholder expectations around the BDC's dividend yield.
- *Timing of shareholder meetings*. For BDCs that are approaching the filing of their proxy materials for their annual meeting, they should consider the practicality of delaying that meeting or convening a special shareholder meeting to seek shareholder approval of a reduction in the BDC's asset coverage. BDCs should consider, among other factors, the quorum and voting requirements associated with the proposals they are seeking to approve at the meeting and whether it is more appropriate to seek asset coverage approval in a special meeting versus the annual meeting.
- *Assess current borrowing arrangements*. BDCs should check existing credit facilities and note indentures, if any, to determine if any provisions need to be amended or any consents need to be obtained to effect a reduction in asset coverage. For instance, language that explicitly requires asset coverage of 200% would need to be negotiated and amended to refer to compliance with the 1940 Act, which would now permit asset coverage of 150%. For BDCs with multiple credit facilities, including those maintained through financing subsidiaries, and multiple series of debt outstanding, this may be a lengthy process.
- *Assess other implications on BDC portfolio structure, including its subsidiaries.* BDCs also may engage in leverage through wholly-owned subsidiaries operating as

small business investment companies (a "SBIC Subsidiary") or off-balance sheet joint venture arrangements. A BDC should review its subsidiary arrangements, as well as any exemptive relief issued by the SEC that permits the BDC to treat certain indebtedness issued by a SBIC Subsidiary as indebtedness not represented by senior securities for purposes of determining the BDC's consolidated asset coverage under the rule amendments, to ensure there are not any inadvertent implications on the BDC's overall leverage structure that would be implicated by the SBCAA amendments. A BDC's joint venture arrangements should be analyzed for similar issues.[15]

- *Review ratings guidelines*. BDCs with rated debt securities also should review their ratings guidelines, which may subject the BDC to stricter leverage restrictions/greater asset coverage requirements than those imposed by the 1940 Act, and which may otherwise preclude the ability of a BDC to rely on the reduced asset coverage provided under the SBCAA. BDCs also should review the relevant indentures to determine what flexibility the BDC has to change or reduce the number of ratings organizations providing debt ratings.
- *Discussions with the BDC's board of directors*. The potential implications of increasing a BDC's leverage profile, as well as changes to its offering process, should be discussed with the BDC's board of directors well in advance of any actual approvals or changes. On the leverage front, topics for discussion could include the BDC's past performance using leverage, leverage profiles of other non-bank lenders, the BDC's overall capital structure and the BDC's related fee and cost profile. With respect to the workload associated with additional leverage and offering reform, sponsors and boards may wish to discuss potential changes to the advisory and/or administrative services the sponsor or its affiliates may need to provide to the BDC.
- *Review public disclosure documents*. BDCs that are seeking to reduce their asset coverage should take this opportunity to review their periodic report disclosure on Forms 10-Q and 10-K, as well as their offering materials, to determine what disclosures should be revised or supplemented in order to comply with these new reporting requirements.
- *Review offering arrangements*. In light of the required amendments to the 1933 Act rules governing securities offerings and market communications, BDCs may wish to get a head-start on reviewing the terms of their underwriting and dealer arrangements in order to permit the BDC to rely on some or all of the rule amendments, although such reliance will not be possible until the earlier of an effective SEC rulemaking or the passage of the year limitation set forth under the SBCAA.

- *Compliance program review*. Chief compliance officers should review the BDC's existing compliance program and determine whether any policies or procedures should be supplemented to address the new reporting and disclosure requirements under Section 61(a) of the 1940 Act. In addition, BDCs likely will need to adopt new policies, or amend existing policies, to provide for compliance with the to-be-amended 1933 and 1934 Act rules and to-be-revised SEC forms.

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[1] Section 18(h) of the 1940 Act defines "asset coverage, " which generally means the ratio of a BDC's total assets less its liabilities and indebtedness other than senior securities (*i.e.*, debt securities and preferred stock) to its senior securities (although the asset coverage ratio works slightly different depending on the type of leverage employed).

[2] The SBCAA did not include all of the reforms that BDCs have sought over recent years. Previous iterations of BDC legislation, including the Financial CHOICE Act of 2017, contained provisions that would have allowed BDCs to have ownership stakes in registered investment advisory firms, issue multiple classes of preferred stock to qualified institutional buyers or "QIBs" and increase their investments in financial institutions. That prior legislation also would have expanded the definition of "eligible portfolio company" under the 1940 Act.

[3] One reason BDCs may be viewed as more attractive investment vehicles than traditional closed-end funds is that BDCs can engage in additional leverage with respect to debt securities due to the reduced asset coverage requirements under the 1940 Act. For traditional closed-end funds, the asset coverage requirement is 300% for debt securities and 200% for preferred stock. Asset coverage of 300% is approximately equivalent to a debt to equity ratio of 1:2; asset coverage of 200% is approximately equivalent to a debt to equity ratio of 1:1; and asset coverage of 150% is approximately equivalent to a debt to equity ratio of 2:1.

[4] Section 61(a)(2).

[5] "Required majority" is defined in Section 57(o) of the 1940 Act to mean both a majority of a BDC's directors who have no financial interest in the transaction and a majority of such directors who are not "interested persons" (as defined in the 1940 Act) of the BDC.

[6] Section 61(a)(2)(D)(i).

[7] Id.

[8] Section 61(a)(2)(A).

[9] Section 61(a)(2)(B)-(C).

[10] Section 61(a)(2)(D)(ii). Shareholders who are eligible to have their shares repurchased by the BDC must be shareholders as of the date the approval to reduce the BDC's asset coverage was obtained. Eligible shareholders may only sell those shares held as of that approval date. BDC shares acquired after the approval date are not subject to the repurchase condition.

[11] Securities Offering Reform, SEC Rel. No. 33-8591 (July 19, 2015). Although BDCs will be able to rely on many of the rules applicable to non-investment company issuers, we expect that a BDC's registration statement and related offering materials will still be reviewed by the Division of Investment Management and not the Division of Corporation Finance.

[12] "Well-known seasoned issuer" is defined in Rule 405 under the Securities Act of 1933, as amended (the "1933 Act"). BDCs and registered investment companies are excluded from this definition.

[13] Rules 168 and 169 under the 1933 Act. Similarly, the SBCAA directed the SEC to amend Rules 138 and 139 under the 1933 Act to permit broker-dealers and other providers of market research to more easily disseminate research reports and other market communications on BDCs. The SBCAA also directed the SEC to amend Rules 134, 163 and 163A, which also will provide BDCs with more flexibility in their market communications.

[14] Rules 433 and 164 under the 1933 Act.

[15] These joint venture arrangements may be informally submitted to the staff of the SEC prior to the commencement of their operations. The joint venture is structured in a manner that permits the BDC to avoid consolidating the joint venture's borrowing arrangements with the BDC's leverage for purposes of 1940 Act compliance. The SEC staff has informally indicated that the leverage of the joint venture should be limited to no more than 4:1.

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For more than a decade, Proskauer has delivered sophisticated and innovative solutions to the most complex issues faced by BDCs, including some of the largest and most strategic transactions in the industry. Our creative, multidisciplinary team counsels BDCs, external advisers and investment banks on formation, capital markets and fund related transactions, financing and regulatory matters across our Registered Funds, Capital Markets, Private Credit, Finance, M&A, Private Equity, Private Funds and Tax practices.