Dechert LLP

Financial Services

June 17, 2004 / NUMBER 16

Proposed Legislation for Business Development Companies

Overview

On April 28, 2004, the House of Representatives approved legislation that is designed to increase access to capital for certain small and developing businesses[1] (the "Bill"). The Bill would do this by amending the Investment Company Act of 1940 (the "1940 Act") in order to relax some of the current restrictions on the companies in which Business Development Companies ("BDCs") may invest.

Background

BDCs are closed-end investment companies that are regulated under the 1940 Act.[2] The principal activity of a BDC is investing in relatively small private companies. BDCs differ significantly from traditional investment companies in that, as described in more detail below, the 1940 Act generally requires BDCs to offer significant managerial assistance to companies in which they invest. The staff and personnel of start-up companies tend to be entrepreneurial and lack the management expertise and skills that BDCs generally offer. Unlike traditional investment companies, a BDC often takes controlling interests in the companies to which it furnishes capital financing. As a result, a BDCs' downstream portfolio company usually is an affiliate of the BDC.

Discussion

- BDCs generally operate in the same manner as traditional closed-end investment companies in that they do not issue redeemable securities, nor do they usually make continuous offerings of their shares. In addition, BDCs may be managed by an in vestment adviser or be internally managed, subject to the oversight of their boards of directors.

1 See Increased Capital Access for Growing Businesses Act (H.R. 3170), attached hereto as Appendix A.

2 As described in more detail below, an investment company that desires to be regulated as a BDC must make an election to be designated as such under Section 54 of the 1940 Act, and then may comply with sp ecific sections of the 1940 Act (Sections 55 through 65) that preempt certain other sections of the 1940 Act that apply to more traditional registered investment companies. In addition, a BDC must register as a public company under Section 12 of the Securities Exchange Act of 1934 (the "1934 Act"), and, in order to make a public offering of its securities, must also register those securities under the Securities Act of 1933 (the "1933 Act").

- BDCs must comply with the general provisions of the 1940 Act, except where those provisions are preempted by Sections 55 through 65 of the Act and the rules thereunder.[3] Under these Sections, a BDC must:
  - be organized under the laws of, and have its principal place of business in any State or States;
  - file a Notification of Election with the SEC to be regulated as a BDC;
  - be operated for the purpose of making investments in "eligible portfolio companies" and make available "significant managerial assistance" with respect to the issuers of those securities.[4]
- Under the current provisions of the 1940 Act, an eligible portfolio company is an issuer that:
  - is organized under the laws of, and has its principal place of business in any State or States;
  - is not a registered investment company nor a company that would be an investment company but for the exclusion set forth in Section 3(c) of the 1940 Act (except for a Small Business Investment Company that is licensed by the Small Business Administration as such and is wholly owned by the BDC); and
  - either (i) does not have outstanding securities that are margin securities (i.e., securities with respect to which an exchange member, broker, or dealer may extend credit under rules of the Federal Reserve), (ii) is controlled by a BDC (with an affiliated person of the BDC serving as a director of the eligible portfolio company), (iii) has total assets of not more than $4,000,000 and capital and surplus of not less than $2,000,000, or (iv) meets other criteria set by SEC rules.[5]
- Permissible Investments.[6] A BDC may not acquire any assets (other than those described in Items 1 through 5 below) (the "70% Total Asset Test"), unless at the time the acquisition is made the assets described in Items 1 through 4 constitute at least 70% of the value of the BDC's total assets (excluding assets described in Item 5). Such assets include:
  - securities of an eligible portfolio company purchased in a non-public offering (a) from the issuer, or (b) from a person who was an affiliated person of the issuer during the previous 13 months;
  - securities of an eligible portfolio company purchased in a non-public offering from any person if there is no ready market for such securities and if immediately prior to such purchase, the BDC owns at least 60% of all outstanding equity securities of such issuer (on a fully-diluted basis); and
  - securities received in exchange for, or distributed on or with respect to, securities described in items 1 and 2 above or pursuant to the exercise of options, warrants or other rights relating to the securities described in such items; and

3 §§2(a)(48) and 59 of the 1940 Act. All subsequent citations are to the 1940 Act

4 Section 2(a)(48)

5 §2(a)(46).

6 In the interest of simplicity, the list of permissible investments below is limited to the most likely kinds of investments to be made. For example, Section 55 also contemplates purchases of securities in the context of bankruptcy proceedings.

- cash, cash items, U.S. Government securities or high quality debt securities maturing in one year or less from the time of investment in such high quality debt securities;

- office furniture and equipment, interests in real estate and leasehold improvements and facilities maintained to conduct the business operations of the BDC, including notes of indebtedness of directors, officers, employees and general partners held by a BDC issued as payment for the BDC's securities pursuant to an allowable executive compensation plan.

- A BDC must make available significant managerial assistance to the companies to which it furnishes capital in order for such companies to qualify as satisfying the BDC's 70% Total Asset Test requirement. Making available significant managerial assistance by a BDC means:

  - any arrangement whereby a BDC, through its directors, officers or employees, offers to provide, and if accepted, does provide, "significant guidance and counsel concerning the management, operations or business objectives and policies of a company;" or

  - the exercise of a controlling influence over the management or policies of a company by the BDC acting individually or as part of a group acting together which controls such company.[7]

- The BDC provisions of the 1940 Act give BDCs additional flexibility to engage in business practices that are generally prohibited by the 1940 Act, but that are essential to companies (such as BDCs) that invest in venture capital entities. The most relevant of these business practices include:

  - as described below, additional flexibility to engage in transactions with certain affiliated or related persons, thereby permitting follow-on investments in portfolio companies (this includes follow-on investments in companies that have gone public);[8]

  - ability to offer stock options, warrants, and rights to directors, officers, employees and general partners,[9] thereby enabling BDCs to recruit and retain experienced management to run the company while also allowing the BDC to use more of its available cash for investments;

  - additional flexibility to invest in securities by reducing the asset coverage limit applicable to other closed-end investment companies from 300% to 200% for their debt issues;[10] and

  - greater access to capital markets by allowing BDCs to sell their stock at less than current net asset value.[11]

- Transactions with Certain Affiliates. A BDC can engage in business transactions with its portfolio companies, including follow-on investments in companies that have gone public. However, as described in more detail below, persons affiliated with the BDC generally cannot engage in transactions with the BDC or its portfolio companies, unless (a) SEC finds by formal order that the transaction does not involve overreaching or (b)

7 Section 2(a)(47)

8 §57(a)-(f) and Rule 57b-1 thereunder.

9 §§61(a)(3)(B) and 57(j)(1).

10 §61(a)(1).

11 §63.

the BDC directors who have no financial interest in the transaction and are also not "interested" directors, find that the transaction does not involve overreaching.

- Transactions requiring approval of the SEC

  Transactions that would otherwise be subject to Sections 17(a) through Section 17(e) of the 1940 Act by a BDC and its affiliated persons, including portfolio companies, require SEC approval if engaged in by any of the following:

  - directors, officers, and employees of the BDC, or any person in a control relationship with those persons other than the BDC itself;
  - any promoter or principal underwriter of the BDC or a person directly or indirectly either controlling, controlled by, or under common control with the BDC (except the BDC itself or any person under the control of the BDC if, other than such control, such person is not under the control of a person who controls the BDC), or affiliated persons.[12]

- Transactions Requiring Board Approval Only

  Persons more distantly related to the BDC can engage in transactions with the BDC or its affiliated persons without SEC approval. However, in this case, the transaction must be approved by those directors with no financial interest in the transaction and by those directors who are not "interested" persons, and certain other persons .[13] These other persons include:

  - any person directly or indirectly owning, controlling or holding the power to vote 5% or more of the outstanding securities of the BDC, an executive officer or director of such person, or a person who directly or indirectly controls, is controlled by, or is under common control with such person;
  - any person who is an affiliated person of a director, officer, employee, or promoter or principal underwriter or an affiliated person of any person directly or indirectly controlling, controlled by or under common control with the BDC (except the BDC itself, or any person under the control of the BDC if, other than such control, such person is not under the control of a person who controls the BDC).[14]

12 "Affiliated Person" of another person means:

any person directly or indirectly owning, controlling or holding the power to vote 5% or more of the outstanding securities of the other person;

any person 5% or more of whose outstanding voting securities are directly or indirectly owned, controlled or held with the power to vote by the other person;

any person directly or indirectly controlling, controlled by or under common control with the other person;

any officer, director, partner (except, in this context, limited partners of investment companies), copartner or employee of the other person (Section 2(a)(3)).

13 See Section 2(a)(19) for the definition of "interested person." Section 2(a)(19) is very long and complicated. Therefore we have not attempted to summarize it here.

14 Section 57. This memorandum describes the general scope of those individuals and entities who are restricted in their dealings with a BDC or its portfolio companies. The language of Section 57(b) and (e) should always be carefully examined to be sure that a proposed transaction is outside the scope of the restrictions on transactions with affiliates.

Finally, in any event, affiliates may, in the "ordinary course of business" sell to or buy merchandise from a BDC or a portfolio company or enter into a lessor-lessee relationship with the BDC or a portfolio company.

Proposed Changes to the Relevant 1940 Act Provisions

The Bill would amend the 1940 Act to expand the pool of businesses in which BDCs are able to invest. In 1980, BDCs were able to invest in approximately 66% of the then 12,000 publicly-held operating companies. Since that time, however, the Federal Reserve has amended its margin rules on several occasions, resulting in a clear decrease in the number of eligible portfolio companies in which BDCs may lawfully invest.

In order to correct these consequences, the Bill would amend the the1940 Act to:

- delete the current requirement that an eligible portfolio company not have outstanding securities that are margin securities, and substitute a requirement that the company not have issued any class of equity securities that is listed for trading on a national securities exchange or traded through the facilities of a national securities association (such as NASDAQ);

- add a new alternative for qualification as a BDC by amending Section 55(a)(1) (a) to allow the BDC to invest in companies with a market capitalization of $250 million or less, and give the SEC authority to adjust those amounts by rule, regulation, or order to reflect changes in one or more generally accepted indices or other indicators for small business; and (b) allow a BDC to invest in a portfolio company if it acquires the securities from the issuer of those securities, if certain conditions are met and the issuer is not an eligible portfolio company because the aggregate value of its outstanding publicly traded equity securities is more than $250,000,000 but not more than $500,000,000, provided that those securities represent not more than 10 per cent of the total assets of the BDC.

Notwithstanding the passage of the Bill in the House of Representatives, the Bill has not been reported out by a Senate committee for the Senate. In addition, is uncertain whether or when the Bill will be considered by the appropriate committee in the Senate, and, if approved thereby, whether the Bill will be approved by the Senate.

■ ■ ■ ■

If you have any questions about the information in this update, please contact one of the attorneys listed below or the Dechert LLP attorney with whom you are in regular contact:

Alan Rosenblat
+1.202.261.3322.....alan.rosenblat@dechert.com

David J. Harris
+1.202.261.3385.....david.harris@dechert.com

Please visit us at www.dechert.com/financialservices.

Appendix A

108th CONGRESS
1st Session

H. R. 3170

To amend the Investment Company Act of 1940 to provide incentives for small business investment, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

September 24, 2003

Mrs. KELLY (for herself and Ms. VELAZQUEZ) introduced the following bill; which was referred to the Committee on Financial Services

---

A BILL

To amend the Investment Company Act of 1940 to provide incentives for small business investment, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the `Increased Capital Access for Growing Business Act'.

SEC. 2. AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940.

(a) DEFINITION OF ELIGIBLE PORTFOLIO COMPANY- Section 2(a)(46)(C) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(46)(C)) is amended--

(1) by striking clause (i) and inserting the following:

`(i) it does not have any class of equity securities listed for trading on a national securities exchange or traded through the facilities of a national securities association as described in Section 15A of the Securities Exchange Act of 1934;';

(2) by striking `or' at the end of clause (iii);

(3) by redesignating clause (iv) as clause (v); and

(4) by inserting after clause (iii) the following new clause:

`(iv) the aggregate value of its outstanding publicly traded equity securities is not more than $250,000,000, except that the Commission may adjust such amounts by rule, regulation, or order to reflect changes in one or more generally accepted indices or other indicators for small business, consistent with the public interest, the

protection of investors, and the purposes fairly intended by the policy and provisions of this title; or'.

(b) ASSETS OF BUSINESS DEVELOPMENT COMPANIES- Section 55(a)(1) of the Investment Company Act of 1940 (15 U.S.C. 80a-55(a)(1)) is amended--

(1) in subparagraph (B), by striking `securities with respect to which a member of a national securities exchange, broker, or dealer may extend or maintain credit to or for a customer pursuant to rules or regulations adopted by the Board of Governors of the Federal Reserve System under Section 7 of the Securities Exchange Act of 1934' and inserting the following: `equity securities listed for trading on a national securities exchange or traded through the facilities of a national securities association as described in Section 15A of the Securities Exchange Act of 1934'; and

(2) by striking `or' at the end of subparagraph (A), by inserting `or' after the semicolon at the end of subparagraph (B), and by inserting after subparagraph (B) the following new subparagraph:

`(C) from the issuer of such securities, which issuer is described in section 2(a)(46)(A) and (B) but is not an eligible portfolio company because the aggregate value of its outstanding publicly traded equity securities is more than $250,000,000 but not more than $500,000,000, if such securities represent not more than 10 per centum of the total assets of the business development company invested in securities described in paragraphs (1) through (6) of this section;'.

BOSTON 200 Clarendon Street · 27th Floor · Boston, MA 02116-5021 · Tel: +1.617.728.7100 · Fax: +1.617.426.6567 **BRUSSELS** 480 Avenue Louise, Box 13 A · 1050 Brussels · Belgium · Tel: +32 2 535 5411 · Fax: +32 2 535 5400 **CHARLOTTE** Bank of America Corporate Center · 100 North Tryon Street · Suite 4000 · Charlotte, NC 28202 · Tel: +1.704.339.3100 · Fax: +1.704.339.3101 **FRANKFURT** Trianon · Mainzer Landstrasse 16 · 60325 Frankfurt a.M. · Germany · Tel: +49 69 971 68 245 · Fax: +49 69 971 68 371 **HARRISBURG** Thirty North Third Street · Harrisburg, PA 17101-1603 · Tel:+1.717.237.2000 · Fax: +1.717.237.2040 **HARTFORD** 90 State House Square · Hartford, CT 06103-3702 · Tel: +1.860.524.3999 · Fax: +1.860.524.3930 **LONDON** 2 Serjeants' Inn · London EC4Y 1LT · UK · Tel: +44 20 7583 5353 · Fax: +44 20 7353 3683 · DX 30 London **LUXEMBOURG** Dechert Luxembourg · Avocats A La Cour · 10 rue de Vianden · B.P. 709 · L-2017 Luxembourg · Tel: +352.45.62.62 · Fax: +352.45.94.95 MUNICH Theresienstrasse 6 · 80333 München · Germany · Tel: +49 89 21 21 63 0 · Fax: +49 89 21 21 63 33 NEW YORK 30 Rockefeller Plaza · New York, NY 10112-2200 · Tel: +1.212.698.3500 · Fax: +1.212.698.3599 **NEW YORK** 30 Rockefeller Plaza · New York, NY 10112-2200 · Tel: +1.212.698.3500 · Fax: +1.212.698.3599 **NEWPORT BEACH** 4675 MacArthur Court · Newport Beach, CA 92660 · Tel: +1.949.442.6000 · Fax: +1.949.442.6010 **PALO ALTO** 975 Page Mill Road · Palo Alto, CA 94304-1013 · Tel:+1.650.813.4800 · Fax: +1.650.813.4848 **PARIS** 55, avenue Kléber · 75116 Paris · France · Tel: +33 1 53 65 05 00 · Fax: +33 1 53 65 05 05 · Palais D 1816 **PHILADELPHIA** 4000 Bell Atlantic Tower · 1717 Arch Street · Philadelphia, PA 19103-2793 · Tel: +1.215.994.4000 · Fax: +1.215.994.2222 **PRINCETON** Princeton Pike Corporate Center · P.O. Box 5218 · Princeton, NJ 08543-5218 · Tel: +1.609.620.3200 · Fax: +1.609.620.3259 **SAN FRANCISCO** One Market · Spear Tower · Suite 1600 · San Francisco, CA 94105-1126 · Tel: +1.415.262.4500 · Fax: +1.415.262.4555 **WASHINGTON** 1775 I Street, NW · Washington, DC 20006-2401 · Tel: +1.202.261.3300 · Fax: +1.202.261.3333