Practical Guidance

# Business Development Company Guide for Capital Markets

**A Practical Guidance® Practice Note by**
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This guide provides information for a securities practitioner in advising a business development company (BDC). It provides an overview of BDCs and discusses applicable securities laws and regulations, the securities offering process, disclosure and corporate governance obligations, stock exchange requirements, commercial and regulatory trends, and practical tips for counsel.

## Overview of BDCs

BDCs are closed-end investment management companies that are specially regulated by the Investment Company Act of 1940, as amended (1940 Act). BDCs invest primarily in small- and middle-market companies in the United States. As a result of their special status under the 1940 Act, BDCs are exempt from much of the regulatory requirements imposed by the 1940 Act on traditional investment companies and generally benefit from pass-through tax treatment (i.e., the BDC is not taxed, and income and expenses are passed through to the owners of the BDC). Given the limited access to, and availability of, financing from traditional bank lenders, BDCs have played an important and increasing role as a crucial source of capital and liquidity for small- and mid-sized companies that may not be able to otherwise obtain financing or do so at attractive rates.

A majority of BDCs raise capital by selling their securities to the public in offerings registered under the Securities Act of 1933, as amended (Securities Act), and list a class of their equity securities on a national securities exchange (e.g., the New York Stock Exchange). Many BDCs (currently, more than 30), though, are privately held, having sold their securities to accredited investors in offerings exempt from registration under the Securities Act. Private BDCs are usually sponsored or formed by private equity firms or financial institutions that have the requisite preexisting relationships with their investors. All BDCs—whether publicly or privately held—must register a class of securities under the Securities Exchange Act of 1934, as amended (Exchange Act), and generally comply with the Exchange Act reporting requirements applicable to publicly held operating companies.

The BDC industry has several major players. Ares Capital Corporation, which finances middle-market companies in a variety of industries, including healthcare, restaurants, power, and real estate, is the BDC with the largest market capitalization and total assets and is listed on The Nasdaq Stock Market (Nasdaq). Owl Rock Capital Corporation, another large BDC that provides financing to middle-market companies in the United States, is listed on the New York Stock Exchange (NYSE). Another major player, Apollo Investment Corporation, is listed on Nasdaq.

For further information on BDCs, see Business Development Companies, Top 10 Practice Tips: Business Development Companies, and Market Trends 2019/20: Business Development Companies.

# Applicable Securities Laws and Regulations

As a condition to being regulated as BDCs under the 1940 Act, BDCs must register a class of securities under the Exchange Act. They also typically register their securities under the Securities Act for sale to the public. For general information about the federal securities laws, see U.S. Securities Laws. Additionally, external investment advisers to BDCs are subject to registration and regulation under the Investment Advisers Act of 1940, as amended (Advisers Act).

## 1940 Act

Section 2(a)(48) of the 1940 Act (15 U.S.C. § 80a-2) defines a BDC as a domestic closed-end company that operates for the purpose of making investments in the securities specified in Section 55(a) of the 1940 Act (15 U.S.C. § 80a-54) and that makes available significant managerial assistance to the issuers of those types of securities. Section 54(a) of the 1940 Act (15 U.S.C. § 80a-53) provides that a company may become a BDC by electing to be subject to Sections 55 through 65 of the 1940 Act.

The 1940 Act requires a BDC maintain at least 70% of its investments in eligible assets before investing in non-eligible assets. As discussed in greater detail below, BDCs are subject to certain other ongoing requirements under the 1940 Act. For example, under Section 56(a) of the 1940 Act (15 U.S.C. § 80a-55), the majority of directors of a BDC must be disinterested persons. Additionally, Section 57 of the 1940 Act (15 U.S.C. § 80a- 56) prohibits certain transactions between a BDC and its related persons, absent approval by the Securities and Exchange Commission (SEC) or, in some cases, its board of directors. Rule 17j-1 under the 1940 Act (17 C.F.R. § 270.17j-1) requires the adoption of a written code of ethics applicable to fund personnel and outside advisers who are involved in a BDC's investment activities. BDCs are also required to implement compliance procedures under the 1940 Act, which must be approved by a majority of the BDC's board and must include appointment of a chief compliance officer. Finally, Section 31 of the 1940 Act (15 U.S.C. § 80a-30) sets forth the recordkeeping requirements for a BDC.

## Securities Act

The Securities Act governs the offer and sale of securities in the United States. Section 5 of the Securities Act (15 U.S.C. § 77e) provides that an issuer seeking to publicly offer and sell its securities must file a registration statement with the SEC. BDCs must use SEC registration statement Form N-2 to register their securities for both initial public offerings (IPOs) and any subsequent public offerings. As discussed in more detail below, the disclosure required by Form N-2 includes a description of the terms of the offering (including the number of shares being offered, underwriting arrangements, and price), intended use of proceeds, risks associated with investing in the BDC, details about the BDC's management, and a description of the BDC's investment policies and objectives.

For information generally about registered offerings, see Registered Offerings: Applicable Laws, Rules, and Regulations, Initial Public Offerings Resource Kit, Top 10 Practice Tips: Initial Public Offerings, Top 10 Practice Tips: Follow-on Offerings, and Follow-On Offerings Resource Kit.

## Exchange Act

A company electing to be classified as a BDC must register a class of securities under Section 12 of the Exchange Act (15 U.S.C. § 78l). Consequently, BDCs are subject to the same periodic reporting requirements as other reporting companies and thus must file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, as well as proxy statements under Section 14(a) of the Exchange Act (15 U.S.C. § 78n), with the SEC.

For more information about registering and reporting under the Exchange Act, see Registration Requirements under Section 12 of the Exchange Act, Public Company Periodic Reporting and Disclosure Obligations, Top 10 Practice Tips: Periodic and Current Public Company Reporting, and Periodic and Current Reporting Resource Kit.

## Investment Advisers Act of 1940

A BDC can have an internal or external investment adviser. If externally advised, a BDC must enter into an investment advisory agreement with its investment adviser, which must be approved by the BDC's directors and stockholders. In addition, the investment adviser must be registered under the Advisers Act. Registration as an investment adviser under the Advisers Act requires, among other things, the adoption of a compliance program and the appointment of a chief compliance officer, as well as the adoption of a code of ethics that will apply to the adviser's directors, officers, and investment personnel.

# Electing BDC Status and Formation Transactions

As discussed above, Section 54(a) of the 1940 Act provides that a company may elect to be treated as a BDC. To do so, the company must file Form N-6F to notify the SEC of its intent to elect to be subject to Sections 55 through 65 of the 1940 Act within 90 days, and then file Form 54A to make the election to be regulated as a BDC. Section 54(a) also provides that a company electing to be treated as a BDC must have registered, or filed a registration statement to register, a class of equity securities under Section 12 of the Exchange Act.

A BDC's initial portfolio of assets may be created in several ways. One common approach is acquiring an existing private investment fund or small business investment company (SBIC). SBICs operate under a license granted by the U.S. Small Business Administration that allows an SBIC to borrow up to $150 million from the U.S. government, in the form of an SBA debenture, which the SBIC may invest in the debt of small business issuers. If appropriate exemptive relief is obtained from the SEC, the SBIC's leverage may be excluded from the BDC's own leverage limits. Fidus Investment Corporation is a large BDC that once operated as an SBIC and converted into a BDC.

Another common formation transaction involves the sale of assets by an affiliated fund to the BDC for cash. This option allows management of the affiliated entities to retain their current assets and grow them through the BDC. Because this formation transaction involves affiliated parties, the sale is often structured for cash rather than an equity stake in the BDC due to the restrictions on affiliated transactions applicable to BDCs (discussed below). Alcentra Capital Corporation (Alcentra) was formed using this approach. Alcentra purchased a portfolio of approximately of $150 million in debt and equity investments from BNY Mellon-Alcentra Mezzanine III, L.P. in exchange for cash and shares of common stock at the Alcentra IPO price. It also purchased $29 million of debt and equity holdings from BNY Alcentra Group Holdings, Inc. under a warehouse facility. Alcentra then entered into a loan agreement with ING Capital LLC to fund the warehouse portfolio purchase as well as the cash portion of the transaction with BNY Mellon-Alcentra Mezzanine III, L.P. Once Alcentra received proceeds from its IPO, it repaid the loan from ING Capital LLC.

A third common formation transaction is the contribution of assets from an affiliated fund in exchange for equity interests in the new BDC, subject to obtaining the required affiliate transaction approvals discussed below under "Related Party Transactions." This approach was taken by Golub Capital, BDC, Inc., WhiteHorse Finance, Inc., and Garrison Capital Inc.

Formation transactions are commonly conducted in conjunction with or following an IPO or other transaction to finance the BDC's acquisition of assets, as discussed below.

# BDC IPOs

As noted above, a BDC must file a registration statement with the SEC on Form N-2 to register its securities for an IPO. The IPO process for a BDC is like that for an operating company. In most IPOs, the SEC will make extensive comments on the registration statement, and the company will respond to these comments and file amendments to the registration statement. This review process can take weeks or months depending on the extent of the comments and any disputes between the company and the SEC over the company's responses. The SEC will not declare the registration statement effective until all its comments are resolved to its satisfaction. After all comments have been resolved and the registration statement amended, the BDC may submit an acceleration request to have the registration statement declared effective by the SEC.

For more information on IPOs and other registered offerings, see Registered Offerings: Applicable Laws, Rules, and Regulations, Initial Public Offerings Resource Kit, Top 10 Practice Tips: Initial Public Offerings, Top 10 Practice Tips: Follow-on Offerings, and Follow-On Offerings Resource Kit.

For more information on the SEC review process, see SEC Review Process, SEC Comment Letter Responses, IPO Prospectuses: Avoiding and Responding to Common SEC Comments, and Top 10 Practice Tips: Responding to SEC Comment Letters.

## Form N-2 Disclosure

The prospectus included in Form N-2 requires extensive disclosure about the BDC and the offering, including:

- Costs and expenses to be payable by the BDC
- Financial information about the BDC, including management's discussion and analysis (MD&A)
- Plan of distribution of the securities being offered
- Use of proceeds of the offering

- Description of the BDC, including its investment objectives and policies and risk factors associated with an investment in the BDC
- Management, including its board of directors, investment advisers, portfolio managers, and other service providers
- BDC's capital stock, long-term debt, and other securities, and the tax consequences to investors of an investment in the securities being offered

If the BDC has identified, but not yet purchased, any potential portfolio companies, the Form N-2 must describe (1) the BDC's general criteria for identifying portfolio companies and (2) the identified portfolio companies generally. The prospectus must identify any portfolio company in which the BDC owns an interest at the time of the IPO and provide the following details: the nature of the portfolio company's business; the general terms and the amount of all loans made to the portfolio company; the relationship of the portfolio company to the BDC; and the class, title, and percentage of class and value of any securities of the portfolio company held by the BDC.

In addition to the information required in the prospectus, Part B of Form N-2 requires disclosure of substantial additional information related to the issuer's (1) investment objective and policies; (2) management, control persons, and principal security holders; (3) investment advisory and, portfolio management services, and brokerage allocation and other services; (4) tax status; and (5) financial statements. Part C of Form N-2 requires further information about the issuer, its control persons, and its investment adviser(s).

## Selected Disclosure Topics

As noted above, the disclosure required by Form N-2 is extensive and includes disclosures required of operating reporting companies. The required information must also be provided in the periodic reports and other documents filed by BDCs pursuant to their reporting obligations under the Exchange Act following their IPO.

### *Risk Factors*

There are numerous risks common to BDCs that are disclosed in their registration statements and reports and other documents filed with the SEC, including:

- The lack of public trading of the portfolio investments, which makes it difficult to assess the fair value of the investments
- Conflicts of interest that could impair returns on investments
- Limitations on co-investment
- Inability to fund below net asset value (NAV)
- Reliance on the external investment adviser to retain key personnel
- Competitiveness of the investment market
- Increased risk in investing in the BDC following the recent reduction in mandated asset coverage ratio from 200% to 150%, if applicable
- Loss in BDC status resulting in the entity being regulated as a closed-end investment company under the 1940 Act and losing the exemptions afforded to BDCs
- Risks related to the transition from LIBOR to the Secured Overnight Financing Rate, or SOFR

For additional information, see Top 10 Practice Tips: Risk Factors, Risk Factor Drafting for a Registration Statement, and Market Trends 2020/21: Risk Factors.

### *Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)*

MD&A includes management's assessment of the company's financial performance as well as the trends that may affect the BDC's future performance. For BDCs, this section typically includes an overview of portfolio and investment activity and often covers the fair market value of the BDC's portfolio company investments, the distribution of the investments based on credit ratings, investment income, operating expenses (including management fees and incentive fees paid to an external investment adviser, if any), terms of the investment advisory agreement, valuation of portfolio investments, and tax considerations. For information about preparing MD&A generally, see Management's Discussion and Analysis of Financial Condition and Results of Operations and Management's Discussion and Analysis Section Drafting Checklist.

### *Financial Statements and Related Disclosures*

BDCs are subject to the same financial statement and related disclosures as operating companies under Regulation S-X, as modified by the special provisions of Article 6 of Regulation S-X, which apply solely to registered investment companies and BDCs, and certain provisions of Article 12 of Regulation S-X.

On October 13, 2016, the SEC adopted a new reporting regime for registered investment companies that included amendments to Article 6 and Article 12 of Regulation S-X that apply to BDCs. The amendments (1) require new, standardized disclosures regarding fund holdings in open futures contracts, open forward foreign currency contracts, and open swap contracts, and additional disclosures regarding fund holdings of written and purchased option contracts; (2) updated the disclosures for other investments and investments in and advances to affiliates, as well as reorganized the order in which some investments are presented; and (3) amended the rules regarding the general form and content of fund financial statements. The amendments require prominent placement of details regarding investments in derivatives in a fund's schedule of investments, rather than allowing such schedules to be disclosed in the notes to the financial statements, as previously was the case. See Investment Company Reporting Modernization [Release Nos. 33-10231; 34-79095; *IC-32314], 2016 SEC LEXIS 4075*.

## Due Diligence for BDC IPOs

The due diligence process is one of the most significant and time-consuming aspects of a securities offering, particularly an IPO. It is a critical exercise for the BDC, the underwriters, and their respective counsel, as it helps with, among other things:

- Limiting potential liability of the offering participants under the federal securities laws
- Ensuring the offering documents are high quality, and the disclosure and marketing documents are accurate and complete
- Assisting the underwriters in accurately valuing the company and pricing the offering
- Supporting the legal opinion letters and negative assurance (or 10b-5) letters to be provided by counsel for the company and the underwriters
- Identifying actions to be taken to prepare the company for successfully completing the IPO and becoming a public company

Given the significance of the due diligence process, it will usually entail a comprehensive investigation of all material legal, business, financial, and accounting information regarding the company and require gathering and verifying all the material information included or incorporated by reference in the offering document.

Counsel for the underwriters will typically conduct the legal due diligence and may prepare a due diligence list requesting specific documents. These will include basic corporate documents (certificate of incorporation, bylaws, and board of director and board committee meeting minutes); material agreements, particularly the investment advisory agreement and the BDC's administration agreement; financing arrangements; co-investments or joint transactions; valuation information; litigation matters; and information about directors and officers. The underwriters, with assistance from their counsel, will be responsible for conducting the business and financial due diligence investigation.

The legal due diligence review should also include an analysis of whether the BDC should request any no-action relief from the staff of the Division of Investment Management (Staff) of the SEC. Companies request no-action letters from the Staff that it will not recommend that the SEC take enforcement action against the requesting entity if it engages in a specified action or transaction or offers a particular service or product. Because BDCs are limited by the 1940 Act in their ability to undertake transactions with affiliates (discussed below), such as co-investments, joint exit, and restructuring transactions, and having a broker-dealer affiliate serve as a principal underwriter, they may have to seek no-action or exemptive relief from the Staff to engage in any of these types of transactions. Accordingly, diligence efforts should focus on whether an affiliate relationship exists in any such transaction that would warrant requesting no-action relief.

It is also important to review the BDC's asset valuation policy to ensure that it complies with industry standards, as well as with the requirements for BDCs under the 1940 Act. In addition, any valuation opinions or reports should be reviewed to ensure that the BDC is complying with its valuation standards.

Investment advisers to BDCs are subject to registration and regulation under the Advisers Act. The diligence process also should include a thorough analysis to confirm compliance by a BDC's external investment adviser with all applicable Advisers Act requirements and that the BDC's board of directors has conducted the review and approval procedures required under the 1940 Act for the BDC's advisory agreement(s).

For more information on due diligence, see Due Diligence for Securities Offerings Resource Kit, Due Diligence Interviews, and Top 10 Practice Tips: Underwriters' Counsel Due Diligence for Securities Offerings.

## Key Documents in the IPO

There are several important documents in the IPO process.

### *Underwriting Agreement*

The underwriting agreement is the main agreement between the parties in a public offering of securities. It sets forth the relationship between the issuer and the underwriters, typically acting in a syndicate. While there may be many underwriters participating in the deal, typically three or four underwriters will act as representatives for the syndicate and sign the agreement.

The underwriting agreement for a BDC offering will usually include a representation by the company that it meets the eligibility requirements for Form N-2 and that the offering documents do not contain any material misstatements or omissions. A representation and warranty common to BDC underwriting agreements is that, to the BDC's knowledge, each portfolio company is current in all material respects with all of its obligations under the applicable portfolio company agreement and that there have been no breaches or events of default under such portfolio company agreements, except to the extent that any such breach or event of default would not reasonably be expected to result in a material adverse effect (as defined in the underwriting agreement) to the BDC. Another common representation is that the terms of the BDC's advisory agreement comply in all material respects with the applicable provisions of the 1940 Act and the Advisers Act and that the necessary approvals from the BDC's board of directors and stockholders have been obtained in accordance with Section 15 of the 1940 Act (15 U.S.C. § 80a-15). Additionally, cybersecurity representations and warranties are becoming increasingly common in all underwriting agreements, not just those of BDCs, and essentially state that the company has appropriate controls in place to protect against a cybersecurity breach and that there has not been a breach of the company's systems.

Another issue that typically arises in negotiating underwriting agreements for BDC offerings is whether the BDC's investment adviser and the BDC are making representations and indemnifying the underwriters on a joint and several basis (this is the most common approach).

Like most operating company underwriting agreements, BDC underwriting agreements typically provide that the BDC will pay all expenses incident to the performance of its obligations under the underwriting agreement. Finally, and as discussed immediately below, the underwriting agreement will provide for lock-up letters from the BDC's executive officers and directors.

For practical tips on how to negotiate an underwriting agreement, see Top 10 Practice Tips: Negotiating an Underwriting Agreement. For more details on underwriting agreements used in public offerings, see Underwriting Registered Securities Offerings. For a form of underwriting agreement, see Underwriting Agreement (Primary Offering).

### *Lock-Up Agreements*

The underwriters in equity offerings, particularly IPOs, typically require that the issuer and its officers, directors, and principal stockholders execute lock-up agreements, which restrict them from selling their company securities for a specified period after the public offering. The purpose of a lock-up agreement is to minimize any disruption in the trading market for the company's securities. The lock-up period for most BDC IPOs is 180 days. The lock-up agreement is almost always included as a form in the underwriting agreement.

For more information on lock-up agreements, see Market Trends 2020/21: Lock-Up Agreements and Top 10 Practice Tips: Lock-Up Agreements. For a form of lock-up agreement, see Lock-Up Agreement (IPO).

### *Comfort Letters, Legal Opinion Letters, and 10b-5 Letters*

The underwriting agreement will include among the conditions to closing that the underwriters receive comfort letters from the BDC's independent accounting firm and legal opinion letters and negative assurance (10b-5) letters from both issuer's and underwriters' counsel.

The company's independent auditors will deliver a comfort letter to the underwriters typically upon the execution of the underwriting agreement. The comfort letter affirms the auditor's independence from the company and sets forth the specific accounting procedures undertaken for the audit of or review of the company's financial statements, as well as certain agreed-upon procedures in relation to information included in, or incorporated by reference into, the applicable prospectus. The accountants will also be required to deliver a "bringdown" comfort letter at the closing of the offering. For more information and practical tips regarding comfort letters, see Top 10 Practice Tips: Comfort Letters and Comfort Letter Review and Negotiation Checklist.

Counsel to the BDC and the underwriters will deliver their respective legal opinion letters and negative assurance letters to the underwriters at the closing of the offering. For forms of these legal opinions, see Legal Opinion (IPO Closing) (Issuer's Counsel) and Legal Opinion (IPO Closing) (Underwriter's Counsel). For more information about negative assurance letters and a form of letter, see 10b-5 Letters and 10b-5 Letter (IPO).

# Follow-On BDC Offerings

Following its IPO, a BDC may engage in a variety of registered offerings to obtain additional investment capital.

## Shelf Offerings

A BDC that meets the requirements of General Instruction I.A. of Form S-3 may file a registration statement on Form N-2 for an immediate, delayed, or continuous offering (i.e., a shelf registration). General Instruction 1.A requires the issuer to:

- Be a U.S. company with its principal business operations in the United States or its territories
- Have a class of securities registered under Section 12(b) of the Exchange Act or a class of equity securities registered pursuant to Section 12(g) of the Exchange Act or be required to file reports pursuant to Section 15(d) of the Exchange Act (15 U.S.C. § 78(o))
- Have been subject to the requirements of Section 13 or 15(d) of the Exchange Act and have filed all the material required to be filed pursuant to Sections 13, 14, or 15(d), for a period of at least 12 calendar months immediately preceding the filing of the registration statement –and¬–
- Have filed in a timely manner all reports required to be filed during the 12 calendar months and any portion of a month immediately preceding the filing of the registration statement, other than certain current reports on Form 8-K

BDCs typically use shelf registration statements to issue debt and equity securities. Debt securities are issued by BDCs from time to time in takedowns from either traditional shelf registrations or medium-term note (MTN) programs. BDCs also frequently list their debt securities on a national securities exchange (such debt securities are referred to as baby bonds due to their small face amounts). Equity securities are issued by BDCs from time to time either in discrete takedowns from shelf registrations or in at-the-market (ATM) offerings, as described in more detail below.

A shelf offering is helpful for BDCs that trade at a premium to their NAV for only a short, and typically unpredictable, period. Having an effective shelf registration statement enables a BDC to access the capital markets when needed or when market conditions are favorable. The shelf registration statement can be filed with the SEC and reviewed while the BDC's common stock is trading at a discount to its NAV and then can be used to conduct an offering of the BDC's shares when market conditions permit (i.e., the BDC's stock is trading at a premium to NAV) or following approval from its stockholders for below NAV issuances. The typical SEC review process for an initial shelf registration statement is approximately 30 to 45 days from the initial filing, and sometimes the SEC Staff will advise the issuer that the registration statement will either not be reviewed or will be subject to only a limited review. Takedowns from an effective shelf registration can be completed without SEC Staff review or delay.

The SEC generally limits the cumulative dilution to a BDC's current NAV per share that a BDC may incur while using a shelf registration statement to sell shares of common stock at a price below NAV. In accordance with SEC Staff guidance, a BDC may complete multiple offerings under an effective shelf registration statement only to the extent that the cumulative dilution to the BDC's NAV per share does not exceed 15%. Once the cumulative dilution exceeds 15%, the BDC must file a post-effective amendment to the shelf registration statement or file a new shelf registration statement.

For more information about shelf registration, see Shelf Registration and Top 10 Practice Tips: Shelf Registration Statements and Takedowns. For more information about MTN programs, see Medium-Term Note (MTN) Programs and Market Trends 2020/21: Medium-Term Note Programs.

## Rights Offerings

A BDC may also issue rights (under a shelf registration statement or a registration statement filed just for the rights offering, typically on Form S-3) that allow its stockholders to subscribe for voting securities even when its common stock is trading below NAV, subject to certain limitations. The rights issued provide that the BDC's existing stockholders may purchase, on a pro rata basis, newly issued shares of the BDC's common stock at an exercise price typically set at a significant discount to the market price of the common stock. A rights offering may be a useful way of raising capital while avoiding stockholder approval requirements under the 1940 Act. The rights issued may be transferable or nontransferable. A transferable rights offering permits the subsequent sale of such rights in the open market. The SEC Staff has generally taken the position in various no-action letters that no more than one additional share of common stock may be issued for every three shares of common stock currently outstanding in connection with a transferable rights offering priced below NAV. Due to the absence of dilution to existing stockholders, nontransferable rights offerings are not subject to the same limitation.

For more information about rights offerings, see Rights Offerings and Rights Offering Checklist.

### ATM Offerings

ATM offerings are becoming increasingly used as a cost-efficient alternative for BDCs seeking to raise capital. An ATM offering is an offering of securities into the existing trading market for that class of securities at other than a fixed price (1) on, or through the facilities of, a national securities exchange, or (2) to or through a market-maker. Therefore, the price at which securities are sold in an ATM offering will vary because the price is based on the trading price of the securities at the time of the offering. An ATM, or equity distribution, program provides a means for a BDC to conduct ATM offerings from time to time using a shelf registration statement to or through a broker-dealer acting either on a principal or agency basis.

For more information about ATMs, see At-the-Market Offerings. For information about recent ATM trends, see Market Trends 2020/21: At-the-Market Equity Offerings. For practical tips on ATM offerings, see Top 10 Practice Tips: At-the-Market Offerings.

## Recent Securities Offering Developments

In the last few years, the SEC has adopted new rules and amended other rules that affect the conduct of registered of offerings by BDCs.

On September 25, 2019, the SEC adopted new Rule 163B (17 C.F.R. § 230.163B) and related rule amendments under the Securities Act to permit all companies regardless of size or reporting status, including BDCs, to use "testing-the-waters" communications in registered offerings. (Previously, only emerging growth companies could engage in such communications.) Rule 163B enables any BDC, or any person authorized to act on the BDC's behalf, to make oral and written offers to qualified institutional buyers (as defined in Securities Act Rule 144A (17 C.F.R. § 230.144A)) and institutional accredited investors before or after the filing of a registration statement to gauge investors' interest in an offering of securities by the BDC. For more information about the Rule 163B, see Testing the Waters for All – New Rule 163B Expands TTW to All Issuers: First Analysis and IPO Process: Permitted Communications. See also Solicitations of Interest Prior to a Registered Public Offering [Release No. 33-10699], 2019 SEC LEXIS 3572.

On April 8, 2020, the SEC adopted final rule amendments, mandated by the Small Business Credit Availability Act, to modernize the offering-related provisions of the Securities Act and the communications safe harbors available to investment companies, including BDCs, and accompanying amendments to Form N-2. The new rules allow BDCs to avail themselves of the securities offering and communication rules that have long been available to operating companies. Among the most important developments changes were allowing (1) BDCs to qualify as well-known seasoned issuers (WKSIs) to the extent that they meet the reporting history and public float requirements for WKSI status, and thus engage in certain communications and rely on expedited shelf registration provisions available to WKSIs; (2) non-WKSI BDCs to use more streamlined shelf registration statement procedures; and (3) BDCs to rely on a number of important communications safe harbors for registered offerings. The rule and form amendments became effective on August 1, 2020. See Securities Offering Reform for Closed-End Investment Companies [Release Nos. 33–10771; 34–88606; IC–33836], 2020 SEC LEXIS 994. For additional information about these rule and form amendments, see SEC Adopts Securities Offering Reform for BDCs and Other Closed-End Investment Companies: Client Alert Digest.

On October 7, 2020, the SEC adopted a new rule designed to streamline and enhance the regulatory framework for funds that invest in other funds (fund of funds arrangements). New Rule 12d1-4 (17 C.F.R. § 270.12d1-4) creates a consistent framework for fund of funds arrangements that replaces the previous regulatory approach that relied on various SEC exemptive orders and varied based on the type of acquiring fund. The scope of permissible acquiring and acquired funds under Rule 12d1-4 is broader than that permitted by the SEC's exemptive orders. In particular, Rule 12d1-4 permits a BDC to acquire the securities of any registered investment company or other BDC in excess of the limits imposed by Section 12(d)(1) of the 1940 Act. BDCs may rely on Rule 12d1-4 as both acquiring and acquired funds. However, Rule 12d1-4 prohibits a BDC from controlling an acquired fund and requires a BDC that holds more than a certain percentage of an acquired fund's outstanding voting securities to vote those securities in a prescribed manner to minimize the influence that the BDC may exercise over the acquired fund. The effect of the rule on the number of acquiring BDCs is limited because BDCs are prohibited from making any investment unless, at the time of the investment, at least 70% of the BDC's total assets are invested in securities of eligible portfolio companies, which do not include funds. See Fund of Funds Arrangements [Release Nos. 33-10871; IC-34045], 2020 SEC LEXIS 4559.

# Stock Exchange Listing Requirements

Publicly held BDCs may list their securities on the NYSE or Nasdaq.

### NYSE

NYSE Manual 102.04B sets forth the initial listing standards for BDCs, which are largely the same as the non-BDC initial listing requirements. The only initial listing requirement unique to BDCs is that a BDC must have $75 million in global market capitalization and the market value of the shares to be publicly held must be $60 million.

### Nasdaq

NASDAQ Equity Rule 5315(d) provides the initial listing requirements for equity securities of a BDC on the Nasdaq Global Select Market, which are largely the same as the general listing requirements. However, BDCs do not have to meet the valuation requirements in Rule 5315(f)(3) but instead must have a market value of listed securities of at least $80 million.

For more information, see NYSE and Nasdaq Listing Requirements Compliance and Securities Exchange Compliance Resource Kit.

# Continuous Disclosure and Corporate Governance

BDCs are subject to the reporting obligations under the Exchange Act and to corporate governance requirements under both the Exchange Act and the 1940 Act.

### Exchange Act

BDCs must file quarterly reports on Form 10-Q, annual reports on Form 10-K, and current reports on Form 8-K under Section 13(a) (15 U.S.C. § 78m) and proxy and information statements under Section 14(a) (15 U.S.C. § 78n) of the Exchange Act. Further, the beneficial ownership reporting requirements of Section 13(d) and the insider reporting requirements and short-swing profit rules under Section 16 (15 U.S.C. § 78p) of the Exchange Act apply to BDC securityholders. Publicly held BDCs must, like other reporting companies, adopt policies and procedures reasonably designed to prevent violations of the federal securities laws and, accordingly, comply with the corporate governance and other requirements of the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

For resources related to public company reporting and under the Exchange Act, see Public Company Periodic Reporting and Disclosure Obligations, Top 10 Practice Tips: Periodic and Current Public Company Reporting, and Periodic and Current Reporting Resource Kit. For resources regarding proxy statements under the Exchange Act, see Proxy Statement and Annual Meeting Resource Kit. For information about beneficial ownership and insider reporting under the Exchange Act, see Beneficial Ownership under Section 13 of the Exchange Act and Section 16 Compliance, Insiders, and Liability.

On March 12, 2020, the SEC adopted amendments to the accelerated filer and large accelerated filer definitions in Rule 12b-2 under the Exchange Act (17 C.F.R. § 240.12b-2). The amendments were intended to reduce the number of issuers that qualify as accelerated filers and thus to reduce compliance costs for smaller reporting companies. BDCs may qualify for non-accelerated filer status under amended Rule 12b-2 if they meet the requirements of the smaller reporting company revenue test using their annual investment income as the measure of annual revenue, although they will continue to be ineligible to be smaller reporting companies. Additionally, under amended Rule 12b-2 certain low-revenue BDCs will not be subject to the auditor attestation requirements of Section 404(c) of SOX (15 U.S.C. § 7262(b)) regarding internal control over financial reporting. In addition, these low-revenue BDCs are not subject to the shorter SEC reporting deadlines for accelerated and large accelerated filers.

For more information about the Rule 12b-2 amendments, see SEC Adopts Amendments to Accelerated and Large Accelerated Filer Definitions: First Analysis. See also Accelerated Filer and Large Accelerated Filer Definitions [Release No. 34-88365], 2020 SEC LEXIS 698.

### 1940 Act

The 1940 Act imposes a variety of requirements on BDCs, including with respect to:

- Boards of directors
- Related party transactions
- Capital structure requirements
- Advisory agreements
- Fidelity bonds
- Investment restrictions

Because lawyers should be aware of the 1940 Act and the Advisers Act provisions governing the operations and activities of BDCs, legal teams advising a BDC should include an attorney familiar with those regulatory schemes.

### *Board of Directors*

Section 56(a) of the 1940 Act (15 U.S.C. § 80a-55) requires a BDC to have a majority of directors that are not "interested persons," as defined in Section 2(a)(19) of the 1940 Act (15 U.S.C. § 80a-2) (generally, persons who are independent of management and have no affiliation with the BDC other than as a director), on its board (independent directors). Interested persons include officers, directors, and other employees of the BDC, and 5% stockholders (affiliated persons); immediate family members of affiliated persons; any interested person of any investment adviser or principal underwriter to BDC; and any person, partner, or employee of any person who at any time in the last two completed fiscal years has acted as legal counsel for the BDC.

In addition to the responsibilities and liabilities associated with independent directors of public companies, BDC independent directors have certain unique duties. Although registered investment companies and BDCs generally may not engage in joint transactions with affiliates, BDCs may, under Section 57 of the 1940 Act (15 U.S.C. § 80a-56) (as discussed below) undertake joint transactions with second-tier affiliates so long as approved by a majority of the BDC's independent directors. Further, BDCs often are granted no-action relief or exemptive relief from the SEC that permits them to co-invest with affiliates of the BDCs' external investment adviser. The independent directors are responsible for ensuring that any proposed transaction is consistent with the interests of the stockholders or partners of the BDC and is consistent with the BDC's policy as recited in its filings with the SEC and its reports to stockholders or partners, and that the conditions of any no-action or exemptive relief are strictly observed.

BDC boards of directors are also responsible for valuing the BDCs' portfolio holdings in the absence of readily available market values under the 1940 Act. A BDC must establish and maintain, and receive board of director approval of, valuation policies to assess accurately the value of its portfolio holdings. BDCs must mark their loan portfolios to fair value on a quarterly basis for financial statement purposes and any unrealized gains or losses must be reflected. Fair value is determined by the BDC's board of directors and management, typically working together with both third-party valuation firms and internal auditors.

Given that a BDC must report its NAV quarterly, board meetings must be held in conjunction with the filing of each report on Form 10-Q and Form 10-K to allow for the proper board approval of such valuations. A BDC board must also approve the BDC's investment advisory agreement(s) on adoption and annually thereafter. Generally, these board meetings must be in person. However, on February 28, 2019, the SEC's Staff issued a no-action letter to the Independent Directors Council, 2019 SEC No-Act. LEXIS 73, permitting board members of a BDC to vote by telephone, video conference, or other remote means in certain circumstances. This modernized position softens, but does not eliminate, the burden for BDCs and their boards to adhere to certain in-person voting requirements.

In response to the global COVID-19 pandemic, on March 13, 2020 (as amended on March 25, 2020), the SEC issued an order, partly superseded by an order dated June 19, 2020, granting relief to funds, including BDCs, from the in-person voting requirements under the 1940 Act to approve investment advisory agreements, principal underwriting agreements, auditors, and plans regarding distribution-related payments from fund assets, subject to satisfying certain conditions. On June 26, 2020 (as amended on January 5, 2021), the SEC issued an updated public statement that its March 2020 order would remain in effect indefinitely as boards of directors of BDCs continue to face obstacles meeting the in-person voting requirements of the 1940 Act. In particular, the SEC recognized that some restrictions and concerns related to travel are likely to continue for some time and stated that it will provide advance notice before terminating its relief from the in-person voting requirements.

### *Related Party Transactions*

Of particular importance are the prohibitions imposed by Section 57 of the 1940 Act (15 U.S.C. § 80a-56) against the following types of transactions (restricted transactions):

- An affiliate may not knowingly sell any securities or other property to the BDC or a company controlled by it, unless either (1) the BDC is the issuer of the securities or (2) the affiliate is the issuer of the securities, and the security is part of a general offering to holders of its securities.
- An affiliate may not knowingly purchase from the BDC or a company controlled by it any security or other property, except securities issued by the BDC.
- An affiliate may not knowingly borrow money or other property from the BDC or a company controlled by the BDC (subject to limited exceptions).
- An affiliate is prohibited from knowingly effecting any joint transactions with the BDC or a company controlled by it in contravention of SEC rules.

Notwithstanding the statutory prohibitions, a BDC may engage in a restricted transaction that, depending on the nature of the proposed transaction and the parties involved, has been approved by a majority of the board of directors, including a majority of disinterested members, or for which exemptive relief has been received from the SEC. Historically, although the SEC has granted exemptive relief for both joint investment and joint exit transactions, these types of investments are subject to compliance with conditions intended to protect investors.

Restricted transactions with the following first-tier affiliates of a BDC are prohibited unless the BDC receives prior approval from the SEC:

- Any director, officer, or employee of the BDC
- Any entity that a director, officer, or employee of the BDC controls
- A BDC's investment adviser, promoter, general partner, or principal underwriter, or any person that controls or is under common control with such persons or entities, or is an officer, director, partner, or employee of any such entities

Restricted transactions with the following second-tier affiliates are prohibited unless a majority of the directors or general partners who are not interested persons of the BDC and who have no financial interest in the transaction approve the terms of the transaction, including that the consideration to be paid or received is reasonable and fair to the stockholders or partners of the BDC and does not involve overreaching, and that the proposed transaction is consistent with the interests of the stockholders or partners of the BDC and with the BDC's policy as recited in its filings with the SEC and its reports to shareholders or partners:

- Any 5% stockholder of the BDC, any director or executive officer of, or general partner in, a 5% stockholder of the BDC, or any person controlling, controlled by, or under common control with such 5% stockholder.
- Any affiliated person of a director, officer, employee, investment adviser, principal underwriter for or general partner in, or of any person controlling or under common control with, the BDC.

A controlled affiliate is a downstream affiliate of a BDC whose securities are more than 25% owned by the BDC. In accordance with SEC Staff guidance, these controlled affiliates are typically treated the same as a second-tier affiliate when engaging in restricted transactions with the BDC. Lawyers should pay particular attention to this aspect as the affiliated transaction prohibitions of Section 57 flow-through to all controlled affiliates of the BDC. For example, if a BDC owns 30% of one company, that company would not be able to purchase securities from a first-tier affiliate of the BDC unless the BDC were to obtain prior SEC approval.

### *Capital Structure Requirements*

A BDC is subject to certain limitations on capital structure. Historically, BDCs were required to maintain an asset coverage ratio of 200%. This means that debt and senior securities could not exceed half of the BDC's total assets. In addition, no dividends could be declared on common stock unless the BDC's debt and senior securities had an asset coverage of 200%. However, Section 61 of the 1940 Act (15 U.S.C. § 80a-60), as amended in March 2018 by the Small Business Credit Availability Act, reduced the asset coverage requirement applicable to electing BDCs from 200% to 150%. This reduction allows BDCs to maintain a maximum 2:1 debt-to-equity leverage ratio.

The reduced coverage ratio can be approved by the BDC in one of two ways. A majority of the BDC's board of directors, including a majority of its disinterested directors, may approve the decreased asset coverage ratio; however, the decreased ratio will not be effective until one year following such approval. Alternatively, a majority of the BDC's stockholders may approve the decreased asset coverage ratio, which would become effective upon approval. In either scenario, a BDC that opts to rely on the reduced asset coverage requirement must publicly disclose within five business days its election to do so and disclose the BDC's existing leverage ratio and risks associated with increasing the leverage ratio. A BDC, the securities of which are not traded on a national securities exchange, is required to offer its stockholders an opportunity to have their shares repurchased by the BDC following its approval to increase the leverage ratio.

BDCs may issue common stock, more than one class of senior secured debt, and warrants and options, subject to certain limitations. A BDC must sell shares of its common stock at NAV, unless prior stockholder approval is obtained or the BDC is engaging in a rights offering. Lawyers may advise BDCs to seek stockholder approval at the BDCs annual meeting to provide the BDC with the ability to raise capital when shares are trading below the NAV.

On February 25, 2020, the SEC granted an exemptive order (FS Energy and Power Fund FS/EIG Advisor, 2020 SEC LEXIS 2476) permitting a non-traded BDC to offer investors multiple classes of shares. Section 61 of the 1940 Act (15 U.S.C. § 80a-60), by applying Section 18 of the 1940 Act (15 U.S.C. § 80a-18) to BDCs, prohibits BDCs from issuing multiple classes of equity. The exemptive order provides a new path for non-traded BDCs to potentially offer separate classes of shares with different investment, pricing, and fee and expense structures. Previously, only mutual funds and certain registered closed-end funds (such as interval funds) had been able to offer multi-class share structures. Any non-traded BDC seeking to rely on similar exemptive relief must agree to provide a degree of liquidity to its stockholders like that provided by an interval fund and must also comply with Rule 18f-3 under the 1940 Act (17 C.F.R. § 270.18f-3).

### *Advisory Agreements*

An externally managed BDC must enter into an advisory agreement with any third party that will provide it with investment advisory services. This agreement is subject to certain requirements of Section 15 of the 1940 Act (applied through Section 59 of the 1940 Act (15 U.S.C. § 80a-58)). The agreement must have board approval initially, and the board must approve the agreement annually thereafter. The agreement must also be approved by the BDC's stockholders. Finally, as discussed above, external investment advisers are also subject to the regulatory requirements of the Advisers Act.

To discharge its fiduciary duties when evaluating the adviser's fee as part of its annual review of the investment advisory agreement renewal, a BDC's board of directors must request and review such information as may be reasonably necessary to evaluate the terms of the agreement. In evaluating the advisory fee, including under Section 36(b) of the 1940 Act (15 U.S.C. § 80a-35), the board should consider the quality and nature of the services being provided to the BDC; the profits realized by the adviser through its relationship with the BDC; whether or not economies of scale, if present, are shared with investors; the investment performance of the BDC and the adviser; and fee structures of similar entities. No single factor is dispositive in the board's evaluation of the investment advisory agreement.

### *Fidelity Bond*

A BDC must maintain a bond issued by a fidelity insurance company to protect the BDC against larceny and embezzlement. The amount of coverage under the bond depends on the BDC's assets. Every officer and employee who has access to funds and securities must be covered by this bond in accordance with Rule 17g-1 under the 1940 Act (17 C.F.R. § 270.17g-1).

### *Investment Restrictions*

Under Section 55(a) of the 1940 Act, a BDC must generally have at least 70% of its total assets in the following investments: privately issued securities purchased from issuers that are eligible portfolio companies; securities of eligible portfolio companies that are controlled by a BDC and of which an affiliated person of the BDC is a director; privately issued securities of companies subject to a bankruptcy proceeding, reorganization, or similar proceeding, or otherwise unable to meet their obligations without material assistance; cash, cash items, government securities, or high quality debt securities maturing in one year or less; and office furniture and equipment, interests in real estate, and leasehold improvements and facilities maintained to conduct the business of the BDC.

BDCs are also required to make significant managerial assistance available to their portfolio companies, which can include providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company.

Under Section 205(b)(3) of the Advisers Act (15 U.S.C. § 80b-5), BDCs are permitted to provide performance-based compensation to advisers that does not exceed 20% of a profit-sharing plan. An internally managed BDC may also compensate management through the use of cash compensation. Externally managed BDCs that receive incentive fees cannot participate in any equity-based compensation plans.

### *Other 1940 Act Considerations*

As discussed above, that board of directors of a BDC must include a majority of independent directors, meaning persons who are not interested persons under Section 2(a)(19) of the 1940 Act. Other requirements include:

- A custodian meeting the requirements of Section 26(a)(1) of the 1940 Act to hold the BDC's investment securities (Rule 17f-4) (17 C.R.F. § 270.17f-4)
- A code of ethics that addresses investments by officers and directors and transactions among related parties, as well as the BDC's related reporting and recordkeeping requirements (Rule 17j-1)
- Restrictions on investments in other investment companies as well as restrictions on the percentage interest of a BDC held by an investment fund (Rule 12d1-4)
- Limitations on indemnities, bookkeeping and records requirements, compliance policies and procedures (Section 31) and Section 38 (15 U.S.C. § 80a-37) of the 1940 Act
- Requirements that the BDC's investment adviser have and comply with policies and procedures required under the Advisers Act (Rule 206(4)-7) (17 C.F.R. § 275.206(4)-7)

# Tax Considerations

There are special tax issues that apply to BDCs. BDCs are typically organized as limited partnerships to obtain pass-through tax treatment. However, a BDC cannot be a publicly traded partnership under the U.S. federal tax laws. Therefore, if a BDC is organized as a partnership, its interest cannot be traded on a securities exchange unless it qualifies for one of the exemptions to be treated as a publicly traded partnership for tax purposes. Recently, BDCs have been organized as corporations and obtained pass-through tax treatment by qualifying as regulated investment companies (RICs) under Subchapter M of the Internal Revenue Code of 1986, as amended. To qualify as a RIC, a BDC must, among other things, elect to be treated as a RIC, distribute substantially all (i.e., 90%) of its taxable income each year, and meet certain income and asset diversification tests. At least 90% of a RIC's gross income must be derived from passive sources. At the close of each quarter, a RIC must be adequately diversified, by meeting specified asset diversification tests. When advising BDCs, either in the formation or offering stage, it is important to include a tax lawyer to address the broad range of tax issues applicable to BDCs.

# Regulatory Trends

On November 30, 2018, the SEC adopted rules and rule amendments designed to promote research on mutual funds, exchange-traded funds, registered closed-end funds, BDCs, and other similar closed-end funds. The SEC took this action in furtherance of the mandate in the Fair Access to Investment Research Act of 2017. New Securities Act Rule 139b (17 C.F.R. § 230.139b) is intended to promote greater access to research for investors in funds and establishes a safe harbor for brokers or dealers to publish or distribute research reports on investment funds under certain conditions. For more information about this safe harbor, see Research Report Safe Harbors. See also Covered Investment Fund Research Reports [Release Nos. 33-10580; 34-84710; IC-33311], 2018 SEC LEXIS 3606.

Additionally, as noted above, due to the global COVID-19 pandemic, on April 8, 2020, the SEC announced temporary, conditional exemptive relief for BDCs to enable them to make additional investments in their existing portfolio companies. The relief provided additional flexibility for BDCs to (1) issue and sell senior securities to provide capital to such companies and (2) participate in investments in such companies alongside certain private funds that are affiliated with the BDC. The relief continued until December 31, 2020, and was subject to certain investor protection conditions, including specific requirements for obtaining an independent evaluation of the issuances' terms and approval by a majority of a BDC's independent board members. With respect to BDC co-investment, the SEC is now considering requests from individual firms for similar exemptive relief on a case-by-case basis. Furthermore, until March 31, 2022, the SEC's Division of Investment Management will not recommend enforcement should any BDC continue to participate in the co-investment transactions described above.

On November 2, 2020, the SEC adopted Rule 18f-4 under the 1940 Act (17 C.F.R. § 270.18f-4) to regulate the use of derivatives by BDCs by providing a more comprehensive approach to the regulation of a BDC's use of derivatives. Rule 18f-4 permits BDCs to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under Section 18 of the 1940 Act (15 U.S.C. § 80a-18) and imposes a uniform set of conditions for such transactions. Conditions include implementation of a derivatives risk management program and a limit on the BDC's use of leverage. BDCs will have until August 19, 2022, to comply with Rule 18f-4. See Use of Derivatives by Registered Investment Companies and Business Development Companies [Release No. IC-34084].

On July 6, 2020, the SEC adopted amendments to 1940 Act Rule 0-5 (17 C.F.R. § 270.0-5) establishing an expedited review process for exemptive applications under the 1940 Act that are substantially similar to other recently approved applications and introduced a new time frame for applications outside of the expedited procedure. The amendments are intended to make the application process more efficient and transparent. Expedited review will be available if an application is substantially similar to two other applications for which an order granting relief has been issued within two years of the date of the application's initial filing. See Amendments to Procedures With Respect to Applications Under the Investment Company Act of 1940 [Release No. IC-33921], 2020 SEC LEXIS 2673.

# Commercial Trends

Beginning in 2010, the number of IPOs completed by BDCs steadily increased. Recently, however, the number of IPOs has declined, and there have only been a few major BDC IPOs in the last three years.

Trinity Capital Inc. (Nasdaq: TRIN), an internally managed BDC, completed an IPO in February 2021. The IPO priced at $14.00 per share, raising net proceeds of approximately $105.4 million. Keefe, Bruyette & Woods, A Stifel Company, Wells Fargo Securities, and UBS Investment Bank acted as joint book-running managers. Trinity Capital primarily provides debt, including loans and equipment financing, to growth-stage companies, including venture- backed companies and companies with institutional equity investors.

Owl Rock Capital Corporation (NYSE: ORCC), a BDC externally managed by an indirect subsidiary of Owl Rock Capital Partners LP, completed an IPO in July 2019. The IPO priced at $15.30 per share, raising approximately $153.0 million in gross proceeds. Goldman Sachs & Co. LLC, BofA Securities, Inc., RBC Capital Markets, LLC, SunTrust Robinson Humphrey, Inc., and Wells Fargo Securities, LLC acted as joint book-running managers for the IPO. This BDC primarily invests in senior secured or unsecured loans, subordinated loans, and mezzanine loans. In connection with the IPO, the BDC's board of directors approved a stock repurchase plan to acquire up to $150 million in the BDC's common stock under a Rule 10b5-1 plan.

In November 2018, Bain Capital Specialty Finance (NYSE: BCSF), a BDC externally managed by a subsidiary of Bain Capital Credit, LP, completed an IPO. The IPO priced at $20.25 per share, raising approximately $151.9 million in gross proceeds. BofA Merrill Lynch, Morgan Stanley, Goldman Sachs & Co. LLC, Citigroup, Credit Suisse, Wells Fargo Securities, and Keefe, Bruyette & Woods acted as joint book-running managers for the IPO. BCSF's primary focus is investing in middle-market companies with between $10.0 million and $150.0 million in annual earnings before interest, taxes, depreciation, and amortization.

While the number of IPOs has declined, private BDCs have emerged as a popular alternative for sponsors seeking to access the BDC structure, with over 30 private BDCs currently in the market. The private BDC structure provides sponsors an alternative that combines elements of a private fund with elements of a traditional BDC. For instance, a private BDC must still comply with the 1940 Act governance and investment limitations and restrictions applicable to publicly held BDCs. However, a private BDC may include committed capital calls in its structure, similar those used by private investment funds, to allocate capital when investment opportunities arise and provide investors with a defined liquidity event.

Another advantage to the private BDC structure is that, instead of using a Form N-2 for an IPO, private BDCs may file a Form 10 to register under Section 12 of the Exchange Act, which is typically subject to a shorter review period by the SEC.

On May 30, 2018, the SEC's Division of Investment Management issued an exemptive order permitting private BDCs to conduct exchange offers in which BDC investors, including directors and officers of a BDC, may exchange their BDC shares for shares in a new split-off extension fund. The new split-off extension fund would receive a pro rata portion of the BDC's assets and liabilities, including each of the BDC's portfolio investments, in proportion to the percentage of the BDC shares exchanged. The exemptive relief was requested to allow the BDC's investment adviser to also act as the investment adviser of the new split-off extension fund (which would be authorized to conduct an IPO or otherwise list its securities) and avoid potentially triggering common control prohibitions under the 1940 Act. As private BDCs do not have publicly traded shares, this new exchange option is expected to provide private BDC investors with a liquidity opportunity following the extension fund's IPO.

BDCs have faced a significant amount of investor activism in recent years, as investors have questioned whether management fees and management interests generally align with stockholder interests, especially during prolonged market dislocations. There has also been an increase in consolidation in the BDC sector recently, driven by the shares of many listed BDCs trading below their NAV, an increased interest in filling gaps in the kinds of assets under management, and a push to maximize stockholder value. One of the largest acquisitions was when PennantPark Floating Rate Capital Ltd. acquired MCG Capital Corporation on April 28, 2015. Another significant acquisition was completed on February 3, 2020, when Crescent Capital BDC, Inc. acquired Alcentra Capital Corporation.

There also has been an increased interest in joint ventures throughout the BDC sector in recent years, driven primarily by a desire to increase portfolio yields. Many BDCs have entered into senior loan fund (SLF) joint ventures. SLFs are investment vehicles, whereby the BDC and a third party (typically an insurance company or asset manager) commit capital to invest in unitranche (a combination of senior and subordinated debt) and first lien secured loans. Ares Capital Corporation, Capitala Finance Corporation, and New Mountain Finance Corporation have all entered into these types of arrangements in recent years. For recent BDC trends, see Market Trends 2019/20: Business Development Companies.

# Practice Tips

Set forth below is a list of helpful practical tips both for in-house and outside counsel to BDCs:

- In-house lawyers should consider the affiliate transaction constraints of the BDC structure when evaluating the steps involved in a BDC's initial formation transaction.
- In-house lawyers should consider the potential benefits of a private BDC structure in the context of an identified portfolio of assets.
- The external legal team should include 1940 Act lawyers and tax lawyers, in addition to capital markets lawyers, from the beginning of a BDC transaction to ensure compliance with all regulations governing BDCs.
- Outside counsel should analyze various precedent BDC offerings and structures when forming a new BDC and participating in a securities offering to ensure that current legal trends and market practices in the BDC sector are followed.
- A number of public BDCs have experienced dramatic fluctuations in their stock price, trading volume, and market capitalization as a result of the recent market downturn triggered by the COVID-19 pandemic. Consequently, lawyers should assess how these changes may have affected their BDC clients' status as large accelerated, accelerated, or non-accelerated filers.

For additional practical tips, see Top 10 Practice Tips: Business Development Companies.

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Anna Pinedo is a partner in Mayer Brown's New York office and co-leader of the Global Capital Markets practice. She concentrates her practice on securities and derivatives. Anna represents issuers, investment banks/financial intermediaries and investors in financing transactions, including public offerings and private placements of equity and debt securities, as well as structured notes and other hybrid and structured products.

She works closely with financial institutions to create and structure innovative financing techniques, including new securities distribution methodologies and financial products. She has particular financing experience in certain industries, including technology, telecommunications, healthcare, financial institutions, REITs and consumer and specialty finance. Anna has worked closely with foreign private issuers in their securities offerings in the United States and in the Euro markets. She also works with financial institutions in connection with international offerings of equity and debt securities, equity- and credit-linked notes, and hybrid and structured products, as well as medium term note and other continuous offering programs.

In the derivatives area, Anna counsels a number of major financial institutions acting as dealers and participants in the commodities and derivatives markets. She advises on structuring issues as well as on regulatory issues, including those arising under the Dodd-Frank Act. Her work focuses on foreign exchange, equity and credit derivatives products, and structured derivatives transactions. Anna has experience with a wide range of transactions and structures, including collars, swaps, forward and accelerated repurchases, forward sales, hybrid preferred stock and off-balance sheet structures. She also has advised derivatives dealers regarding their Internet sites and other Internet and electronic signature/delivery issues, as well as on compliance matters.

Anna regularly speaks at conferences and participates in panel discussions addressing securities law issues, as well as the securities issues arising in connection with derivatives and other financial products. She is the co-author of the leading capital markets treatise, *Corporate Finance and the Securities Laws*, published by *Wolters Kluwer* (6th Ed., updated 2020); co-author of *A Deep Dive Into Capital Raising Transactions*, published by the International Financial Law Review (2020); co-author of *JOBS Act Quick Start* (International Financial Law Review, 2013; updated 2014, 2016); contributor to *OTC Derivatives Regulation Under Dodd-Frank: A Guide to Registration, Reporting, Business Conduct, and Clearing* (Thomson Reuters, first ed. 2014, second ed. 2015, third ed. 2016, fourth ed. 2017); co-author of *Considerations for Foreign Banks Financing in the US* (International Financial Law Review, 2012; updated 2014, 2016); co-author of *Liability Management: An Overview* (International Financial Law Review, 2011, updated 2015); co-author of *Structuring Liability Management Transactions* (International Financial Law Review, 2018); co-author of *Covered Bonds Handbook*, published by Practising Law Institute (2010, updated 2012-2014); co-author of the treatise *Exempt and Hybrid Securities Offerings*, published by Practising Law Institute (2009, second ed. 2011, updated 2014, third ed. 2017); and co-author of *BNA Tax and Accounting Portfolio: SEC Reporting Issues for Foreign Private Issuers* (BNA Accounting Policy and Practice Series, 2009, second ed. 2012, third ed. 2016, fourth ed. 2020). Anna is also a contributing author to *Broker-Dealer Regulation* (2011, second ed. 2012, updated 2020), published by Practising Law Institute. She co-authored "The Approaches to Bank Resolution," a chapter in *Bank Resolution: The European Regime* (Oxford University Press, 2016). Anna contributed to *The Future of Bank Funding and Capital: Solutions for Issuers, Opportunities for Investors* (IFR Market Intelligence, 2009). Additionally, Anna co-authored "The Ties that Bind: The Prime-Brokerage Regulation," a chapter in *Global Financial Crisis* (Globe Law and Business, 2009); "The Law: Legal and Regulatory Framework," a chapter in *PIPEs: A Guide to Private Investments in Public Equity* (Bloomberg, 2006); and "The Impact Security: Reimagining the Nonprofit Capital Market," a chapter in *What Matters: Investing in Results to Build Strong, Vibrant Communities* (Federal Reserve Bank of San Francisco and Nonprofit Finance Fund, 2017). Anna is a contributor to Practising Law Institute's "BD/IA: Regulation in Focus" blog.

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Brian is a thought leader and frequently authors articles relating to capital markets trends and topics published by *Thomson Reuters' Practical Law Company*, *the Practicing Law Institute*, *Bloomberg and LexisNexis*. The IFLR1000 2022 guide ranks Brian as a "Rising Star Partner" in the United States for Capital Markets: Equity, and he is also a recommended lawyer by *The Legal 500 US*.

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