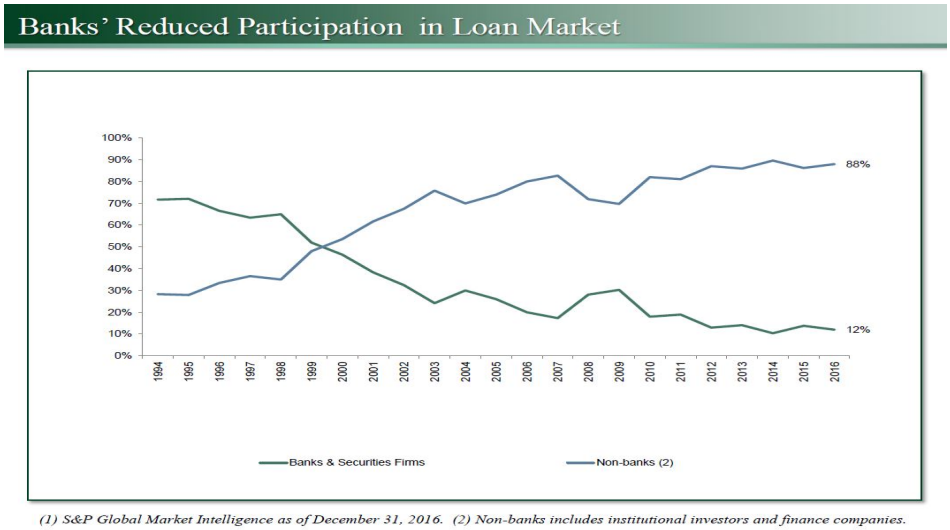
Proposal: Modernize Business Development Companies (BDC) In Order to Increase the Volume, Safety and Transparency of Lending to Small and Medium- Sized Businesses

What is a BDC and Why Does the BDC Statutory Framework Need Reform?

Congress created BDCs in 1980 in a period similar to what we saw following the "Great Recession". Specifically, Congress created BDCs in 1980 to enhance capital access to small- and medium-sized businesses. BDCs make direct investments in smaller, developing American businesses, providing access to capital for companies that may not be able to access capital from traditional sources such as banks. Despite an outdated regulatory regime which has been in place since the early 1980s, the number of BDCs has grown significantly. This growth accelerated following the economic downturn after the 2008-2009 economic recession, where BDCs addressed the needs of small and medium-sized businesses that were starved for capital. Currently, there are over 80 BDCs in the United States and BDC loan balances have more than tripled since 2008. Uniquely, the BDC model gives ordinary investors the opportunity to finance small- and medium- sized companies – effectively "Main Street funding Main Street".

As commercial banks and other traditional financing sources continue to retrench from the business of providing loans to small and medium-sized businesses, BDCs now find themselves at the forefront of the effort to address the unmet capital needs of these businesses. There are nearly 200,000 middle market businesses that represent one-third of private sector GDP, employing approximately 47.9 million people.[1]



(1) S&P Global Market Intelligence as of December 31, 2016. (2) Non-banks includes institutional investors and finance companies.

[1] Source: National Center for the Middle Market http://www.middlemarketcenter.org/Media/Documents/MiddleMarketIndicators/2016-Q4/FullReport/NCMM_MMI_Q4_2016_web.pdf.

Nonetheless, there has been a long term trend of declining bank financing for these businesses and this trend has not abated as the post-2008 recovery has taken hold. There has also been a long-term trend of a reduction in the smaller, regional banks which middle market borrowers have historically depended on. Since 2011, bank lending in this space has continued to be replaced by a variety of non-bank lenders such as BDCs.

In order to continue to provide sufficient access to capital for small and medium-sized businesses, modernization of the BDC regulations is essential. Indeed, modernization will permit BDCs to continue to grow and serve these businesses.

BDC Regulation

BDCs are highly regulated and fully transparent to regulators, investors and the companies in which they invest. Specifically, publicly-traded BDCs are subject to the disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934 and are also subject to additional regulations imposed by the Investment Company Act of 1940. These disclosure and other regulatory requirements are extensive and include, among other things, requirements that BDCs:

- publish a quarterly summary of each investment held by a BDC and the fair value of such investment, which is a significantly greater degree of transparency than that found in other financial services models;

- invest at least 70% of their assets in small and medium-sized U.S. operating businesses; and

- comply with an asset coverage test which requires one dollar of equity for every dollar of debt.

BDCs fall under the supervision of the SEC's Division of Investment Management, the same division which regulates mutual funds. Given that BDCs are more akin to operating companies such as banks and other commercial lenders than to mutual funds, BDCs must often play the part of the proverbial "square peg being in a round hole".

So, the question then becomes how to enable BDCs to fulfill their Congressional mandates as active providers of capital to small and medium-sized businesses, and as well- regulated and transparent vehicles for investors and borrowers alike?

Proposed Reform

To achieve these goals in our current context we propose modernizing BDCs with a handful of modest, common sense changes. The two most significant Congress could make are a small change in the asset coverage test and updating the offering, filing and registration requirements

for BDCs in order to bring these requirements in line with those applicable to other traditional operating companies.[2]

1. Reform of the Asset Coverage Test

As noted above, BDCs are required to maintain a 1:1 debt to equity ratio. Currently, most BDCs maintain an average leverage ratio of 0.5x-0.75x, reflecting a desire and a practical need to maintain adequate "cushion" in the unprecedented, unlikely event of a sudden and steep drop in asset values. This practice is driven in part by the requirement that BDCs "mark-to market" the value of their portfolio companies, which can erode the fair market value of a BDC's holdings due to negative changes in the broader loan market, irrespective of the actual financial performance of such portfolio companies. The maintenance of this cushion has the unintended effect of reducing the ability of BDCs to raise and invest capital, thereby frustrating the original intent of Congress to increase capital to small and medium-sized businesses.

To solve these problems we advocate a modest increase in the BDC asset coverage test from a 1:1 to a 2:1 debt to equity ratio, thereby broadening the universe of potential borrowers that can access loans from a BDC. We do not believe that the proposed change introduces more risk. To the contrary, it should allow BDCs to invest in lower-yielding, lower-risk assets that don't currently fit their economic model. In fact, the current asset coverage test actually forces BDCs to invest in riskier, higher-yielding securities in order to meet the dividend requirements of their shareholders and RIC distribution requirements. We believe that this proposed change will benefit borrowers through greater financing alternatives and a reduced cost of capital and will also benefit shareholders by enabling BDCs to construct more conservative, diversified portfolios.

In addition, this proposed change would be much less than the typical 10:1 or greater ratio typically found in traditional banking institutions and would apply to BDCs the same leverage ratio - 2:1 - as the leverage ratio under the Small Business Investment Company Debenture program, but without government guarantees or implied taxpayer subsidy.

Consistent with the transparency required of BDCs in their SEC disclosure documents, shareholders will be clearly informed (as they are now) of the amount of leverage that BDCs can incur, the amount of leverage actually incurred and any potential risks to them associated with such leverage.

Finally, we would propose significant investor safeguards for accessing additional leverage, including (i) a shareholder vote or (ii) an independent board of directors vote with a 12 month "cooling off" period. These protections will ensure that a BDC's shareholders will be able to decide whether they want to continue to hold shares of a BDC that plans to access additional leverage.

[2] Draft legislative language is attached as Appendix A.

2. Offering Reform

Second, we propose that BDCs be given the ability to use the existing short form and streamlined reporting and registration process under securities laws available to other similarly situated public companies who also have a class of equity securities registered under Section 12 of the Securities Exchange Act of 1934. BDCs often have a very narrow window in which to access the capital markets. Access to this streamlined reporting and registration process under the Federal securities laws, where the information included in a company's periodic reports is integrated seamlessly into a registration statement, would enable BDCs to more efficiently access the capital markets, thereby enabling BDCs to bring this capital more quickly to small and medium-sized businesses.

To fully implement these changes we would propose including BDCs as "well known seasoned issuers" and allow BDCs to make use of an automatic shelf registration. We would further request Congress direct the Commission to amend a series of rules so that BDCs have access to safe harbors available to other operating companies under Rules 168 and 169, Rules 163A and 163, Rules 134, 164, 433, 138, and 139. We would further request Congress direct the Commission to amend Rule 415(a)(1)(x) to clarify that BDCs can be "qualified" to register on Form S-3 even if they are required to register on Form N-2. We would also request similar clarifying amendments to Rule 497 effecting BDC usage of shelf registration and changes to Rule 172 so that BDCs may rely on this "access equals delivery" rule. Finally, we urge Congress to direct the Commission to allow BDCs to use incorporation by reference on Form N-2.

Appendix A

Legislative Language

Reform of the Asset Coverage Test

(a) IN GENERAL.—Section 61(a) of the Investment Company Act of 1940 (15 U.S.C. 80a–60(a)) is amended—

(1) by redesignating paragraphs (2) through (4) as paragraphs (3) through (5), respectively;

(2) by striking paragraph (1) and inserting the following:

"(1) Except as provided in paragraph (2), the asset coverage requirements of subparagraphs (A) and (B) of section 18(a)(1) (and any related rule promulgated under this Act) applicable to business development companies shall be 200 percent.

"(2) The asset coverage requirements of subparagraphs (A) and (B) of section 18(a)(1) and of subparagraphs (A) and (B) of section 18(a)(2) (and any related rule promulgated under this Act) applicable to a business development company shall be 150 percent if—

"(A) within five business days of the approval of the adoption of the asset coverage requirements described in clause (ii), the business development company discloses such approval and the date of its effectiveness in a Form 8–K filed with the Commission and in a notice on its website and discloses in its periodic filings made under section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m)—

"(i) the aggregate value of the senior securities issued by such company and the asset coverage percentage as of the date of such company's most recent financial statements; and

"(ii) that such company has adopted the asset coverage requirements of this subparagraph and the effective date of such requirements;

"(B) with respect to a business development company that issues equity securities that are registered on a national securities exchange, the periodic filings of the company under section 13(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78m) include disclosures reasonably designed to ensure that shareholders are informed of—

"(i) the amount of indebtedness and asset coverage ratio of the company, determined as of the date of the financial statements of the company dated on or most recently before the date of such filing; and

"(ii) the principal risk factors associated with such indebtedness, to the extent such risk is incurred by the company; and

"(C)(i) the application of this paragraph to the company is approved by the required majority (as defined in section 57(o)) of the directors of or general partners of such company who are not interested persons of the business development company, which application shall become effective on the date that is 1 year after the date of the approval, and, with respect to a business development company that issues equity securities that are not registered on a national securities exchange, the company extends, to each person who is a shareholder as of the date of the approval, an offer to repurchase the equity securities held by such person as of such approval date, with 25 percent of such securities to be repurchased in each of the four quarters following such approval date; or

"(ii) the company obtains, at a special or annual meeting of shareholders or partners at which a quorum is present, the approval of more than 50 percent of the votes cast of the application of this paragraph to the company, which application shall become effective on the date immediately after the date of the approval.";

Offering Reform

(a) REVISION TO RULES.—Not later than 1 year after the date of enactment of this Act, the Securities and Exchange Commission shall revise any rules to the extent necessary to allow a business development company that has filed an election pursuant to section 54 of the Investment Company Act of 1940 (15 U.S.C. 80a–53) to use the securities offering and proxy rules that are available to other issuers that are required to file reports under section 13 or section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m; 78o(d)). Any action that the Commission takes pursuant to this subsection shall include the following:

(1) The Commission shall revise rule 405 under the Securities Act of 1933 (17 C.F.R. 230.405)—

(A) to remove the exclusion of a business development company from the definition of a well-known seasoned issuer provided by that rule; and

(B) to add registration statements filed on Form N–2 to the definition of automatic shelf registration statement provided by that rule.

(2) The Commission shall revise rules 168 and 169 under the Securities Act of 1933 (17 C.F.R. 230.168 and 230.169) to remove the exclusion of a business development company from an issuer that can use the exemptions provided by those rules.

(3) The Commission shall revise rules 163 and 163A under the Securities Act of 1933 (17 C.F.R. 230.163 and 230.163A) to remove a business development company from the list of issuers that are ineligible to use the exemptions provided by those rules.

(4) The Commission shall revise rule 134 under the Securities Act of 1933 (17 C.F.R. 230.134) to remove the exclusion of a business development company from that rule.

(5) The Commission shall revise rules 138 and 139 under the Securities Act of 1933 (17 C.F.R. 230.138 and 230.139) to specifically include a business development company as an issuer to which those rules apply.

(6) The Commission shall revise rule 164 under the Securities Act of 1933 (17 C.F.R. 230.164) to remove a business development company from the list of issuers that are excluded from that rule.

(7) The Commission shall revise rule 433 under the Securities Act of 1933 (17 C.F.R. 230.433) to specifically include a business development company that is a well-known seasoned issuer as an issuer to which that rule applies.

(8) The Commission shall revise rule 415 under the Securities Act of 1933 (17 C.F.R. 230.415)—

(A) to state that the registration for securities provided by that rule includes securities registered by a business development company on Form N–2; and

(B) to provide an exception for a business development company from the requirement that a Form N–2 registrant must furnish the undertakings required by item 34.4 of Form N–2.

(9) The Commission shall revise rule 497 under the Securities Act of 1933 (17 C.F.R. 230.497) to include a process for a business development company to file a form of prospectus that is parallel to the process for filing a form of prospectus under rule 424(b).

(10) The Commission shall revise rules 172 and 173 under the Securities Act of 1933 (17 C.F.R. 230.172 and 230.173) to remove the exclusion of an offering of a business development company from those rules.

(11) The Commission shall revise rule 418 under the Securities Act of 1933 (17 C.F.R. 230.418) to provide that a business development company that would otherwise meet the eligibility requirements of General Instruction I.A of Form S–3 shall be exempt from paragraph (a)(3) of that rule.

(12) The Commission shall revise rule 14a–101 under the Securities Exchange Act of 1934 (17 C.F.R. 240.14a–101) to provide that a business development company that would otherwise meet the requirements of General Instruction I.A of Form S–3 shall be deemed to meet the requirements of Form S–3 for purposes of Schedule 14A.

(13) The Commission shall revise rule 103 under Regulation FD (17 C.F.R. 243.103) to provide that paragraph (a) of that rule applies for purposes of Form N–2.

(b) REVISION TO FORM N–2.—Not later than 1 year after the date of enactment of this Act, the Commission shall revise Form N–2—

(1) to include an item or instruction that is similar to item 12 on Form S–3 to provide that a business development company that would otherwise meet the requirements of Form S–3 shall incorporate by reference its reports and documents filed under the Securities Exchange Act of 1934 into its registration statement filed on Form N–2; and

(2) to include an item or instruction that is similar to the instruction regarding automatic shelf offerings by well-known seasoned issuers on Form S–3 to provide that a business development company that is a well-known seasoned issuer may file automatic shelf offerings on Form N–2.

(c) TREATMENT IF REVISIONS NOT COMPLETED IN TIMELY MANNER.—If the Commission fails to complete the revisions required by subsections (a) and (b) by the time required by such subsections, a business development company shall be entitled to treat such revisions as having been completed in accordance with the actions required to be taken by the Commission by such subsections until such time as such revisions are completed by the Commission.