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PRIVATE EQUITY

The Rising Tide of Private BDCs: A New Take on the Traditional Private Credit Fund Structure

BY JOHN J. MAHON

While the business development company, or ''BDC'' structure has grown in popularity over the past decade as a publicly-traded alternative to the traditional private credit fund, the so-called "private BDC", which operates as a BDC from a regulatory standpoint, but functions much more like a private fund from a marketing and investment perspective, has seen increasing interest among credit managers over the past few years. In particular, a properly structured private BDC can help solve certain tax-related challenges that credit managers often face when targeting offshore and tax exempt investors. In addition, private BDCs offer increased transparency and regulatory oversight often craved by certain institutional investors. More importantly, the private BDC model also provides the opportunity to convert to a permanent capital structure in the future. Fund managers considering such structures should plan for the potential hurdles having a regulated fund as part of their broader credit platform can cause, including the restrictions on cross-trades and co-investments with affiliates under the Investment Company Act of 1940, as amended (the ''1940 Act'').

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What Are Private BDCs?

A private BDC operates, from a regulatory perspective, in the same manner as a traditional publicly traded BDC. By electing to be regulated as a BDC under the 1940 Act, a private BDC becomes subject to the same limitations on its capital structure as any publicly traded BDC. For example, a private BDC must still maintain at least a 200% asset coverage ratio (i.e., at least a one to one equity to debt ratio) and may only have one class of common equity. A private BDC must also maintain a board of managers, a majority of whom must not be "interested persons" of the BDC or its adviser. The board of managers has the same general rights and responsibilities as the board of directors of a publicly traded BDC. Private BDCs also file the same public reports, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as any publicly traded BDC would. In addition, private BDCs also typically elect to be treated as "regulated investment companies, or "RICs", for federal income tax purposes, which subjects them to the same source of income, asset diversification and distribution requirements that apply to publicly traded BDCs making a similar election.

What distinguishes private BDCs from their publicly traded kin, though, centers on how they offer and sell interests to investors, as well as their process for obtaining investment capital. For example, while a publicly traded BDC will typically conduct an initial public offer-

ing, followed by a listing of its shares on a national securities exchange, a private BDC markets its interests through a private placement, typically to the same institutional and high net worth investors that would gravitate towards a private fund structure. Similarly, while a publicly-traded BDC receives proceeds from any public offerings up front – potentially before identifying specific investment targets, a private BDC operates using a capital call model more common among private credit funds, with the fund drawing down capital from investors in connection with each separate investment opportunity. Private BDCs also often utilize a limited liability company structure, which tends to mirror the limited partnership structure most common for private credit funds, rather than the corporate structure required for publicly traded BDCs. [Some private BDCs have, however, opted for a corporate structure, issuing new shares to investors in connection with each drawdown of capital.]

What Advantages Do Private BDCs Have Over Traditional Private Credit Funds?

The advantages of a private BDC over a traditional private credit fund fall into three general categories centering on:

- tax and operational advantages;
- marketing advantages; and
- the potential for permanent capital.

From a tax and operational perspective, a private BDC helps solve two potential issues relating to both offshore and tax exempt investors that often affect how a private fund is structured and how it acquires its investment portfolio. Specifically, unlike private credit funds that must often form offshore structures to accommodate offshore and tax exempt investors, with the inherent expense and potential inefficiency that entails, offshore and tax exempt investors may invest directly into a private BDC that has elected regulated investment company (''RIC'') status without triggering the same negative tax consequences. In addition, a private BDC that has offshore investors may still originate new debt investments without triggering tax concerns common for many offshore fund structures. Ultimately this means a more efficient structure, both from a marketing and operational perspective, when compared to the onshore/offshore split often found with new private credit fund launches.

Private BDCs also enjoy certain advantages when it comes to marketing interests to investors. For example, the ability of offshore and tax exempt investors to invest directly in a private BDC, rather than through an offshore feeder or similar structure, simplifies the marketing of the fund over a traditional master feeder credit fund structure. In addition, the regulatory oversight to which private BDCs are subject, coupled with the mandatory reporting requirements under the 1940 Act, provide a distinct contrast to the less fulsome disclosure typically provided by private credit funds. The 1940 Act restrictions on affiliate transactions can also help allay investor concerns regarding self-dealing between a private BDC and its adviser, particularly where the private BDC is part of a larger credit platform.

From the credit manager's perspective, the private BDC also provides an option for permanent capital, depending on its structure. Specifically, private BDCs must contemplate and provide a mechanism to permit conversion to a publicly offered structure. Depending on investor appetite, the right to conduct a public offering can be granted to the board of managers of a private BDC to exercise in its discretion, depending upon market conditions, with no subsequent approval required from existing investors. A credit manager may also impose specific requirements for any subsequent initial public offering, for example including a minimum offering amount and subsequent exchange listing requirement. In addition, for platforms that already an existing publicly traded BDC, a private BDC can be structured to permit its subsequent merger into an existing public BDC in lieu of conducting a separate initial public offering, assuming market conditions favor that alternative approach.

So Why Doesn't Every Credit Manager Have a Private BDC?

While private BDCs offer a number of distinct advantages over traditional private credit funds, those advantages also come with corresponding regulatory burdens that can impact a manager's entire credit platform. For example, to the extent a manager has no other regulated funds within its larger platform, it will need to develop a comprehensive 1940 Act compliance program to monitor compliance with and prevent violations of the 1940 Act. While third party service providers can help develop such compliance programs, it still represents an additional burden not associated with merely launching another private credit fund off of a manager's existing platform. In addition, a private BDC, though not listed on any exchange, still remains subject to the full disclosure and reporting requirements applicable to its publicly traded BDC cousins. Those reporting obligations necessarily go beyond what fund managers typically provide to private fund investors, and can subject a private BDC's disclosure to additional public and regulatory scrutiny.

Private BDCs also must live within the more closely regulated world of the 1940 Act, which means among other things restrictions on how and when they may use leverage, including swaps and other derivative instruments that may create indirect leverage for regulatory purposes. Among other things, a private BDC must generally maintain at least a 200% asset coverage ratio, which roughly approximates a one to one equity to debt ratio. As a result, portfolio assets that typically require greater leverage to achieve attractive returns would prove poor investments within a private BDC structure, in the absence of other structuring options. An adviser to a private BDCs must also typically take its ''carry'' in the form of a fee payment under its advisory agreement, rather than in the form of a carried interest distribution more common among private funds.

In addition, depending on the type of assets it intends to acquire, a private BDC typically cannot engage in cross trades with, or co-invest alongside, affiliated private funds that reside on the same platform in the absence of exemptive relief from the Securities and Exchange Commission (the ''SEC''). The restriction on co-investment transactions under the 1940 Act, in particular, directly impacts how a credit manager may allocate investment opportunities platform-wide. While

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the SEC has recently granted co-investment relief to a number of credit managers, that process remains an arduous one, and a credit manager that lacks such relief must give careful consideration to allocation issues when exploring a potential new private BDC.

Similar to the 1940 Act overlay, most private BDCs elect to be treated as RICs for federal income tax purposes, which requires them to meet certain source of income, asset diversification and distribution requirements. In particular, those RIC requirements can often impact how a private BDC invests, with managers needing to be mindful of the impact of larger portfolio investments and equity investments with pass through tax characteristics, among other things. The RIC distribution requirements can also make it difficult for a manager to grow a private BDC's net asset value over time without additional capital raises.

Finally, given the overlay of the reporting and compliance requirements under the Securities Exchange Act of 1934, as amended (the ''Exchange Act''), larger investors in a private BDC face public disclosure of their respective ownership positions in certain cases. For example, a private BDC must disclosure in its proxy materials each year any owners of 5% or more of its outstanding equity interests. In addition, such larger investors will be subject to their own independent obligation to file beneficial ownership reports under Regulation 13D, to the extent they own 5% or more of a private BDC's equity interests, and under Section 16 of the Exchange Act, to the extent they exceed 10% of a private BDC's equity interests. While these reporting obligations do not necessarily trigger a meaningful burden for investors, they still subject such investors to public disclosure they may typically seek to avoid.

Is a Private BDC the Right Solution for Me?

The private BDC structure provides a number of distinct benefits to asset managers with a credit focus, particular with respect to the ability to market a single investment vehicle to both onshore, offshore and tax exempt investors. In particular, the private BDC model can help ease many of the tax structuring considerations that typically plague private credit funds with meaningful offshore or tax exempt capital, while also providing potential investors with an arguably more robust framework of regulatory oversight. Credit managers also have the ability to convert a private BDC into a permanent capital vehicle if market conditions are favorable. Even with these advantages, though, a credit manager considering a private BDC structure should be cognizant of the regulatory burdens associated with having a regulated fund on its existing credit platform.

For example, a manager that routinely relies on co-investing among managed vehicles for new debt investments may face allocation issues between the private BDC and its affiliated private funds until the manager receives co-investment exemptive relief from the SEC. Any manager contemplating a private BDC launch should also have in place adequate administrative, compliance and back-office support personnel to properly manage the associated reporting and compliance functions. Finally, a manager should carefully consider the investment needs and focus of the proposed private BDC, including whether its leverage requirements and use of derivatives will exceed the leverage ratios permitted under the 1940 Act, and its investment portfolio will meet the source of income and asset diversification requirements applicable to RICs. To the extent a credit manager has adequate resources to manage the regulatory burdens associated with a private BDC, however, the private BDC model can provide an efficient vehicle for addressing many of the tax issues related to offshore and tax exempt investors in private credit funds while providing an investor friendly structure that has the ability to convert to permanent capital in the future.